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Politics this week

May 29th 2003
From The Economist print edition

On the road to peace

AP

Pushed by the United States, Ariel Sharon persuaded his cabinet to accept the Middle Eastern **road map** to peace, albeit with 14 Israeli "reservations". This prepared the way for a meeting next week between Mr Sharon, George Bush and Mahmoud Abbas, the Palestinian prime minister.

See article: Serious about peace

Donald Rumsfeld, America's defence secretary, acknowledged that Iraq may have destroyed its **weapons of mass destruction** before America and Britain went to war against it. In the same speech, he warned Iran that "efforts to try to remake Iraq in Iran's image will be aggressively put down." Tony Blair, Britain's prime minister, visited Basra, Iraq's second city.

See article: The case for war, revisited

Saudi Arabia arrested five men suspected of involvement in the suicide bombings in Riyadh on May 12th, including the alleged mastermind, Ali Abdul Rahman al-Ghamdi.

See article: Arrests in Saudi Arabia

Tremors continued to hit northern **Algeria** after last week's earthquake that killed at least 2,218 people, with many still unaccounted for.

In a referendum, **Rwandans** voted by a huge majority to approve a new constitution, aimed at allowing more democracy without generating more genocide. Multi-party elections, Rwanda's first since the 1960s, must be held later this year. Critics said the new constitution makes it hard to unseat the ruling party.

See article: A referendum in Rwanda

France said that it would send a UN-backed peacekeeping force to eastern **Congo** to quell fighting between ethnic militias there.

Saadi, the son of **Libya's** leader, Muammar Qaddafi, was named in the country's 24-man football squad for African Nations Cup qualifying matches in Botswana and the Democratic Republic of Congo next month. It is not clear if the selectors were swayed more by his footballing skills or his father's job.

Bush pays a visit

George Bush was due to set off on May 30th for a flurry of meetings with world leaders: first Poland; then St Petersburg, to join Russia's president, Vladimir Putin, and other leaders celebrating the 300th anniversary of that city's founding; next, on June 1st, to Evian, in France, to meet leaders of the G8 rich countries (including Russia); then, via a meeting with Arab leaders in Sharm el-Sheikh, in Egypt, to Aqaba, in Jordan, for his meeting with the prime ministers of Israel and the Palestinian Authority. Afterwards, he will visit American troops in Qatar.

See article: Bush goes global

Valéry Giscard d'Estaing, a former French president who chairs the convention preparing the **European Union's constitution**, published most of a draft due to be presented to the EU's heads of government, after further expected last-minute changes, at a summit in Greece on June 20th.

See article: Discord over Giscard's Euro vision

France's government said it would not back down in the face of an expected series of strikes in protest against its plans to reform pensions. A general strike was proclaimed for June 3rd. A one-day strike by air-traffic controllers caused widespread disruption to flights into the country.

AFP

See article: France's government versus the strikers

In regional and municipal elections in **Spain**, the conservative People's Party, led by José María Aznar, who runs the national government, did better than pollsters predicted, scoring only one percentage point less than last time round, in 1999. All the same, the Socialists nosed ahead.

See article: Ballots and bombs

In **Italy** the assorted left also came out marginally on top in local and provincial elections.

Armenia's ruling Republican Party, which is loyal to President Robert Kocharian, seemed to have won a dirty general election on May 25th.

Bold beginnings

Néstor Kirchner, a Peronist, took office as **Argentina's** president. He announced an immediate purge of the armed forces and called for cuts in the debt repayments.

See article: A new start

In **Brazil**, the centrist Democratic Movement party joined President Luiz Inácio Lula da Silva's governing coalition, ensuring him a congressional majority, on paper at least, thus easing the passage of social-security and tax reforms.

See article: Brazil's Congress

In **Peru**, at least 21 people were injured as troops clashed with protesters after President Alejando Toledo, faced with strikes by teachers and health workers, declared a 30-day state of emergency.

Canada's Liberal government unveiled a parliamentary bill that would decriminalise the possession of marijuana for personal use. Meanwhile, Toronto suffered a new outbreak of SARS after a month with no new cases.

See article: Drug policy in Canada

Tax relief

America's Congress passed a **tax-cut** package worth $350 billion over the next decade. This was half the figure demanded by George Bush, but the current level depends on some tax cuts being temporary; assuming politicians are reluctant to reinstate them, the total could be close to $800 billion.

See article: Looking at the Bush tax cut

In an unexpected blow to states' rights, the **Supreme Court** gave state workers the right to sue employers who denied them time off to look after a sick relative.

After a huge **manhunt**, Derrick Todd Lee, a suspect in the killings of five women in Louisiana, was

arrested peacefully outside a tyre store in Atlanta.

Offensive measures

As Indonesia's offensive against separatists in its western province of **Aceh** entered its second week, about 23,000 people were reported to have been forced to flee from their homes. Some 20 tonnes of medical and other aid is due to arrive in the province from UN agencies and the World Health Organisation.

A heatwave in southern **India**, with temperatures up to 47 degrees Celsius (117 degrees Fahrenheit), has killed 489 people in two weeks, the government said.

Reuters

The king of **Thailand** has been granted a patent for making rain. It improves on an existing technique of “seeding” clouds with chemicals.

Peter Hollingworth resigned as **governor-general of Australia** after controversy about his conduct. The prime minister, John Howard, who makes the appointment in consultation with Queen Elizabeth, is under pressure to consult more widely before choosing Mr Hollingworth's successor.

See article: The queen's man bows out

Separatist rebels in the southern **Philippines** called a ten-day ceasefire.

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Business this week

May 29th 2003
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The euro rises

The **euro** hit an all-time high against the dollar, briefly surpassing the level it touched a few days after the launch of the single currency in January 1999. The euro's rise stoked fears of deflation in Germany, where consumer prices rose by only 0.7% in the year to May. It also suggests that the European Central Bank will be under more pressure to cut interest rates at its meeting on June 5th.

Good call

Vodafone reported a loss of £6.2 billion ($9.6 billion) in the year to March 2003, compared with a loss of £13.5 billion the year previously. The British mobile-phone giant had other reasons for cheer. Operating profits rose by 36% to £8.4 billion, and the loss-making write-down of assets did not include the value of its third-generation licences, a widespread cause of misery for competitors.

See article: The next generation of mobile phones

Spain's **Telefonica** launched a bid for **Terra Lycos**. The telecoms firm owns 38% of the internet business and has offered some *euro*1.7 billion ($2.0 billion) for the rest.

Gucci is to repay *euro*1.3 billion ($1.5 billion) to shareholders, rather than keep the cash on its balance sheet. The effect of the Italian luxury-goods house's move is to reduce the amount that Pinault-Printemps-Redoute, a French retail group that won a bidding war for Gucci in 2001, will pay to buy out remaining minority shareholders. This will go some way to easing a cash crunch at PPR.

Up in the air

After years of haggling and hold-ups, seven European countries at last signed up for the A400M, **Airbus's** heavy-lift military-transport aircraft. Belgium, Britain, France, Germany, Luxembourg, Spain and Turkey ordered 180 planes at a cost of *euro*20 billion ($23.5 billion). Europe's fledgling rapid-reaction force will no longer have to rely on American transport—when it gets off the ground.

Boeing landed a large order from America's government. It signed a $16 billion deal to lease 100 tanker aircraft to the United States Air Force.

The slump in the civil-aerospace industry hit **Bombardier**. Profits in the first quarter at the Canadian regional-jet maker slumped by 59% compared with a year ago, to C$81m ($55m). The Canadian company also agreed to delay delivery of an aircraft order from America's Atlantic Coast Airline.

British Airways was reportedly miffed by talk of a link-up between its two biggest rivals at Heathrow, **Virgin** and **BMI**. BA was said to be considering an offer for either airline to prevent a deal. Virgin dismissed BA's suggestion as a “flying pig concept” before adding that it had recently mulled a bid for its arch rival. Sceptics suggested that the rival claims were both pie in the sky.

See article: A fuss over Britain's airlines

The EU's member governments are preparing to hand over "**open skies**" negotiating power to the European Commission, after last year's European Court ruling against bilateral deals on transatlantic routes. This could put more pressure on America to open up its internal market and also boost competition within Europe. Any airline may soon be able to fly to America from any EU country, ending special privileges for national flag-carriers.

A private matter

Switzerland's private banks underwent a flurry of mergers in the hope of coping with rising costs associated with the bear market and waning secrecy that have driven away many traditional customers. EFG announced a takeover of a smaller rival, Banque Edouard Constant; Liechtenstein's LGT bought Schweizerische Treuhandgesellschaft; and France's Société Générale took a big stake in Compagnie Bancaire Genève.

Japan's big banks reported huge annual losses, including the biggest ever recorded, ¥2.4 trillion ($20 billion) by Mizuho. The news came a week after the government was forced to bail out one of the banks, Resona. Despite the losses, massive bad debts, plunging stockmarkets that are eating away capital and the lamentable state of Japan's economy, the four biggest insisted that they would return to profit this year.

Mail bonding

The secretive **Barclay twins** added the home-shopping arm of **GUS** to Littlewoods, their mail-order business, for £590m ($966m). GUS will use the cash to pay down debt. Later, the British retailer announced a healthy pre-tax profit for the year to March of £409m and a partial float of its South African businesses.

Kingfisher, a British big retail group, bowed to pressure from shareholders and changed the pay and incentive scheme for its chief executive and directors. British shareholders, in the midst of a general campaign against corporate greed, claimed another victory.

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Summitry

Now, the waging of peace

May 29th 2003
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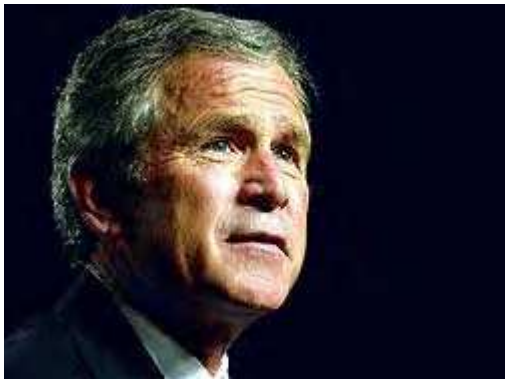
George Bush's unfinished business in France, Russia and, above all, the Middle East



HE HAS won a famous victory. So what does he intend to do with it? That question is going to follow George Bush throughout his foreign travels this coming week—first to Poland, on to an international jamboree in St Petersburg, then to the summit of G8 rich-country leaders in Evian, France, and finally to a proposed series of meetings in the Middle East.

However warm the public diplomacy is made to look, some of Mr Bush's encounters with his fellow world leaders will be frigid. The post-Iraq view from Washington is that Gerhard Schröder won re-election by taking a cheap shot at America's "adventurism", that Jacques Chirac went out of his way to sabotage America's pre-war diplomacy and that Vladimir Putin spurned America's friendship by making himself Mr Chirac's accomplice. For their part, the German, French and Russian leaders continue to say that America's war in Iraq was a mistake (the more so, see article, given the non-discovery of any weapons of mass destruction) and that the Americans cannot be allowed to go around the world starting new ones. In the Middle East, too, Mr Bush will meet Arab leaders he feels have let him down. King Abdullah of Jordan, Crown Prince Abdullah of Saudi Arabia and Egypt's President Hosni Mubarak were vehement critics of America's invasion of Iraq. They now fear for the safety of their own regimes given America's post-war zeal to spread democracy among the Arabs.

Pre-emptive strike

So the scene is set for yet another quarrel between America and some of its allies in Europe and the Middle East? Never under-estimate the capacity of this president to think big. This week Mr Bush astonished friends and foes alike by announcing that he would follow the G8 summit with a summit of his own with Israel's prime minister, Ariel Sharon, and the new Palestinian prime minister, Mahmoud Abbas (also known as Abu Mazen). At a stroke, this has breathed new life into hopes of ending the very conflict which critics of his Iraq policy routinely describe as the core problem of the Middle East and the fount of Islamic terrorism. No matter what happens at the Israel-Palestine summit, Mr Bush's convening of it will have the satisfactory effect of stealing whatever thunder Mr Chirac intended to unleash in Evian. The G8's summiteers cannot wish Mr Bush anything other than godspeed as he heads to the Middle East for his tryst with destiny.

Which raises a question or three. Is Mr Bush's initiative really a tryst with destiny? Does he intend genuinely to invest the time and political capital that will be required if America is to untangle a conflict that has defeated would-be peacemakers for more than half a century? Or is it just a stratagem?

The reason to hope he is genuine is that Mr Bush has never before become so personally involved in this area. In June last year, he gave a speech setting out his "vision" of an independent Palestine arising by 2005 in the lands Israel captured in the 1967 war. But having a vision is easier than having a plan, and the June speech fell far short of a plan. It seemed to impose impossible conditions on the Palestinians, such as requiring them to reform their administration in the West Bank and Gaza, even while those areas were newly occupied by the Israeli army, and to ditch Yasser Arafat, their perennial president. Such conditions made it look as if Mr Bush's real aim was to put Palestine to one side and concentrate on getting rid of Saddam Hussein. It was all of a piece with his early reluctance to copy Bill Clinton, who invested so much in the Camp David summit of 2000, only to be rewarded when it failed with a new and

exceptionally bloody Palestinian *intifada*.

A new Middle East

So what has now made Mr Bush put his own prestige on the line? Iraq, for a start. Even those who say that the war should not have been fought must see that the removal of Mr Hussein has had useful consequences, including some for Palestine. It has left America in a position to bring new pressure on potential spoilers such as Syria and Iran, and the rejectionist guerrillas they succour. By removing a threat to Israel and a source of support for the *intifada*, it has made it safer for Israelis to compromise and harder for Palestinians to believe that they will achieve their aims by violence. It has left Mr Bush with some outstanding promises, such as a promise to the faithful Tony Blair to try as hard for peace in Palestine as Britain's prime minister did in Northern Ireland. It has given America a new incentive to signal to Arabs, and to Muslims at large, that its war against terrorism and rogue regimes is not a war against Islam. Delivering an independent Palestine from Israeli occupation would be just such a signal.

Second, the Palestinians themselves have made peace a little more possible. Indeed, they have come close to meeting the apparently impossible conditions Mr Bush set for them last June. Mr Arafat remains the Palestinians' increasingly nominal president, but in Abu Mazen the Palestinians have chosen a prime minister who has freely declared that the *intifada* of suicide bombings that followed Camp David was disastrous to their own cause. He may not yet have the power to stop all the suicide bombers, but he does at least seem willing—in a way Mr Arafat was not—to make a good-faith effort.

Third, Mr Bush appears to have decided that neither Mr Sharon nor Israel's supporters in the United States are the unbudgeable opponents of territorial compromise they are often painted as. In making his cabinet vote this week to endorse the peace “road map” devised jointly by America, the European Union, Russia and the United Nations, Israel's prime minister showed that he would sooner antagonise the right wing of his own governing coalition than fall out with an American president who has persuaded both Israelis and many American Jews that he can be trusted to protect the safety of the Jewish state. Conventional wisdom holds that an American president gives up on peacemaking in the Middle East as elections approach. In this case, however, Mr Bush is working with a Likud prime minister who has just scandalised his own supporters at home and abroad by stating bluntly that Israel cannot rule indefinitely over more than 3m hostile Palestinians.

By the bleak standards of the Middle East, these changes make for a propitious moment, though they do not mean that peace is nigh. It has been plain at least since Britain's Peel commission suggested it in 1937 that the least bad solution to the conflict between Jew and Arab in Palestine is to partition the area between the Jordan and the Mediterranean between two states. At different times, one side or the other has harboured the illusion that it can have it all. Right now, majorities in both camps claim to support partition. But for partition to work, the Israelis must accept the need to surrender most of the area they colonised after 1967, and the Palestinians must accept that most of the refugees who fled or were pushed out of what is now Israel in the late 1940s will never return.

For both peoples, these are bitter compromises, which will be wrung out of them only by the sustained bullying and cajolery of the superpower. If that is what Mr Bush intends, his foreign critics should offer all their support. Peace in Palestine would not ease all of the tensions between America and Europe, nor resolve all the problems of the Arab world, nor put an end to Islamic terrorism. All of these have wider and deeper causes. In the long run, the Arabs will care at least as much about America's conduct of its own occupation of Iraq. But a president who sorts out Palestine will have made a mark in history. Now is the time for Mr Bush to wage peace.

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Iraq's WMD

Secret weapons

May 29th 2003
From The Economist print edition

Did George Bush and Tony Blair wage war under false pretences?

SADDAM HUSSEIN is (or was) a very bad man. Evidence of his badness is being exhumed daily from the ground of the country he once ruled, and corroborated in his torture chambers and the loot he hoarded while ordinary Iraqis went hungry. But George Bush and Tony Blair told the world that Mr Hussein should be removed not only because of his badness in general, but also because of one particular facet of it: Iraq's weapons of mass destruction (WMD). *The Economist*, for one, found their case persuasive. It now seems possible that it was built on sloppy, or even deceitful, foundations.

One of the main problems with the evidence concerning Mr Hussein's WMD was always that it was both boring and complicated. Many of those who opposed the war never bothered to acquaint themselves with it; many who now allege that the proof was cooked up in London and Washington have forgotten it. Much of the evidence was, in point of fact, compiled by United Nations weapons inspectors during more than a decade of patient labour, complicated by Mr Hussein's attempts to bamboozle them. Then there was Iraq's previous record of making and using WMD. Mr Hussein asked the world to believe, on trust, that he had unilaterally destroyed his noxious weapons and the means of making them.

Did they stretch, or did they lie?

Messrs Bush and Blair could have justified the war on the basis of this record and the inspectors' findings. But they didn't. Citing its own intelligence, America also and dubiously alleged that Mr Hussein was co-operating with al-Qaeda. Mr Bush and Mr Blair claimed that the danger of Iraq's chemical and biological weapons was clear and present, and that from its nuclear programme imminent. They thus portrayed invading Iraq as necessary and urgent, rather than optional and postponable. What has or, rather, hasn't been found in Iraq since the war ended (see article) has called into question not only the integrity of the intelligence that informed these claims, but also that of the governments that made them.

Intelligence is an imprecise business. Governments are obliged to make judgments based on the information their spooks provide, and the level of risk that they are prepared to tolerate. With that in mind, the case against Mr Hussein still looks powerful. It remains more likely than not that incriminating discoveries will be made in Iraq, and that, in the end, a Saddamite WMD programme will be unearthed. But the various reasons offered by the British and American governments as to why the nightmarish arsenals that they conjured up have so far failed to materialise are unpersuasive. Their attempts to finesse their earlier claims are unworthy. Since it now seems unlikely that all their accusations will stack up, Mr Bush and Mr Blair need to prove their own innocence as well as Mr Hussein's guilt.

There is a spectrum of possible explanations for why they may have exaggerated the threat Mr Hussein represented. At one end of it is the possibility that they decided simply to lie. That seems improbable, for it would be too risky. More plausible possibilities include a decision to embroider; incompetent or biased processing of intelligence; the eagerness of spies to please superiors; and sloppy political oversight. All of these are scandalous, albeit in different degrees.

The only way for the world to know where the balance lies between sloppiness and scandal is for both governments to come clean about what they knew (or thought they knew), when and how. The CIA is

conducting a review of all Iraq-related intelligence. To preserve the trust between voters and governments that democracy relies on, and which Mr Bush exploited to wage his war, the results of the review should be made public. Mr Blair should initiate a similar inquiry. Not only his own reputation, but also the legitimacy of Mr Bush's doctrine of pre-emptive war (whether or not it applied to Iraq), hangs on this: if America cannot be relied on to marshal intelligence competently, that doctrine looks much less safe. In the meantime, for both their impartiality and their expertise, Mr Bush should permit the UN inspectors to return to Iraq.

History will judge the second Gulf war on a number of criteria, including how the war itself went (well); how the reconstruction effort progresses (at the moment, fairly badly); what sort of democracy (if any) emerges in Iraq; and how the security of the region and the world are affected. It seems probable that, all things considered, it will turn out to have been a worthwhile enterprise. But those who launched it may themselves emerge with less credit.

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The latest Bush tax cut

Disingenuous and risky

May 29th 2003
From The Economist print edition

There is nothing wrong with tax cuts or tax reform; but don't muddle them up

Get article background

IT IS hard to object to tax cuts—particularly when you are about to receive one. However, even the most conservative American should pause to reconsider the “economic recovery bill” concocted by Congress and George Bush that will hand back some $350 billion over the next decade. Sadly, this giveaway is disingenuous and also something of a gamble.

The first sleight of hand is that $350 billion number. Mr Bush had hoped for twice as much, but Congress has squeezed his tax cuts into a smaller package by setting time limits. For instance, the cuts in dividend taxes and capital gains are due to expire in 2008. At face value, this presents an absurd series of incentives for taxpayers. In fact, the chances of politicians letting the taxes reappear are slim. Add in a little political reality and the true cost of the tax cut could be $800 billion.

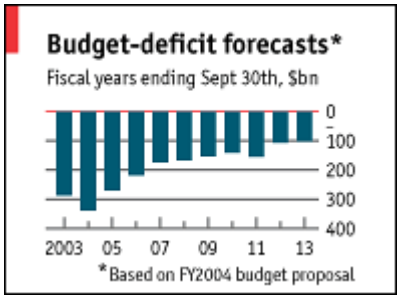
Now consider the next sleight of hand. Mr Bush has muddled up two sensible ideas: the short-term need for a fiscal stimulus to pep up the faltering American economy; and a long-term fiscal reform—namely shifting the tax burden away from investment. Mr Bush has got rid of inheritance tax, at least temporarily. This time his big target was dividend income, which is taxed twice—as corporate profits and as personal income. He wanted to eliminate the latter; Congress has opted to cut the rates roughly in half.

By trying to smuggle in dividend-tax reform as the best way to give the economy an immediate jolt, Mr Bush has improved neither the stimulus nor the long-term fiscal position. There has been fanciful talk from the White House about lower investment taxes delivering an immediate confidence-inspiring boost to the stockmarket (which, incidentally, has not happened). But nobody trying to jumpstart the economy would begin with dividend taxes. True, some of the other measures in the tax cut, such as increasing the child tax credit, may have a more stimulative effect. But Mr Bush looks set to go into the next election having overseen at least 1m net job losses.

The longer-term danger is greater. By equating tax reform with a short-term giveaway, Mr Bush has made his overhaul of the tax system hopelessly one-sided: it is all tax cuts, with no countervailing reforms on the other side of the ledger, such as reorganising Social Security, Medicaid and Medicare. The main long-term fiscal challenge is restructuring these “entitlement” programmes to cope with the demands of the retiring generation of baby-boomers by the end of this decade.

Less pork, more beef

This is where the gamble comes in. Mr Bush's budget deficit is excusable for the moment: the war on terror has been expensive, and it makes no sense to run a surplus in a downturn. But the deficit is rising: even before this tax cut, the official forecast was for $1.8 trillion over the next decade (see chart). And he has still done nothing about entitlements. Rather than reforming the health-care system, Congress seems set to add to the number of free pills old people can get. “Social-Security reform” has so far been merely a slogan.



In the 1980s, Ronald Reagan also cut taxes (from far more draconian levels) and failed to cut spending: the result was an entrepreneurial boom, but also huge deficits, which were reduced only when Mr Bush's

own father raised taxes. Bush the younger is heading down the Reagan road, with the additional huge problem of those retiring baby-boomers. Unless he changes tack, he could leave a terrible mess behind him.

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Property prices

The next bubble to pop?

May 29th 2003
From The Economist print edition

Your home may be worth less than you think

STILL smarting from losses on equities and a shrivelling private pension? Wait until you see what happens to the value of your house. Far too many people have decided in recent years that, in these uncertain times, the safest investment is bricks and mortar. Real house prices in many places have been rising at their fastest-ever rate. Can this go on?

The answer, as our survey in this week's issue argues, is clearly no. But will house prices flatten or will they crash? The fate of the world economy could hinge on the answer. Since the stockmarket slump, rising property prices have been a crucial prop for many economies. If house prices were now to go into reverse, this could have far graver consequences than did the fall in stockmarkets. Households have more money tied up in property than in shares, and they tend to borrow more. Falls in GDP after previous housing busts have been larger than after stockmarket crashes.

Most analysts still argue that a sharp fall in house prices is unlikely. They claim that low interest rates mean that people can afford to pay more for a home. But real interest rates are not low. If nominal interest rates are low mainly because inflation is low, wages will also grow more slowly, so future mortgage-interest payments will be a bigger burden than in the past.

A second argument deployed by house-price bulls is that previous busts have been triggered by higher interest rates. With inflation so low, interest rates are unlikely to go up now. In the near future, this argument may be right. But both Japan and Germany, where house prices have fallen steadily over the past decade, show that low interest rates are no protection against a decline in house prices. A third popular argument for why house prices can keep rising focuses on supply constraints. Yet this argument too is flawed. Hong Kong is shorter of land than anywhere in the world; yet property prices there have fallen by two-thirds in the past five years.

Bogus arguments puffing house prices higher have led investors mistakenly to ignore more traditional gauges of value. Yet just as share prices cannot for long outpace the growth of profits, so house prices cannot long rise faster than incomes. Looking at ratios of house prices to both rents and average wages, our survey finds that houses are significantly overvalued in 13 countries. The ratios are near all-time highs in America, Australia, Britain, Ireland, the Netherlands and Spain.

None of this means that house prices are sure to collapse; they could just stagnate. But there are reasons to expect prices to fall in nominal terms. In the past, high inflation has allowed overvalued assets to adjust without the need for a big drop in prices. In a world of near-zero inflation, nominal prices are more likely to need to fall. A second reason why a decline in nominal house prices is likely is the growth of the “buy-to-let” market in such countries as Britain, Australia and Ireland. House prices are stickier than equity prices, because the financial and emotional cost of selling is large; if prices wobble, most owner-occupiers stay put, as they have to live somewhere. But buy-to-let investors are more likely to sell.

Even so, the housing market may not have a sudden big crash, as the stockmarket has. Instead, house prices are more likely to slide slowly down over the next four years. With the global economy already so fragile, and some countries poised on the brink of deflation, the result will be uncomfortable at best—and painful at worst. But that is what happens when bubbles are blown up and burst.

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The European Union's constitution

Nothing like good enough, so far

May 29th 2003
From The Economist print edition

Europe's draft constitution-in-the-making needs drastic revision

AP

OH FOR the prose of Philadelphia. The American constitution's beauty and effectiveness lie in its simplicity, its clarity and its brevity. What we have seen of the Europeans' vaunted equivalent, a year into its gestation but with barely three weeks to go before its first version is due to be born (see article), is an ugly hybrid that differs from its supposed American forebear precisely by virtue of its opposites: it is complex, confusing and absurdly long. Yet there are graver objections. The emerging document is riddled with dangers that, unless headed off, would push the Union in quite the wrong direction and stir up the bad blood it was meant, from its inception, to prevent.

This is not to belittle the notion of a constitution *per se*. It was a good idea to have a document to consolidate the sprawling bodies of past treaties, to clarify and explain the European Union's purpose, and in particular to spell out where the limits of its burgeoning powers lie. The arrangements to which the Union's current members are party are already intrusive and complicated enough to require a new codification of rules, especially if they are to function adequately when the club swells from 15 members today to 25 in a year's time.

Too much zeal

Moreover, the Union's desire, reflected in the document under discussion, to build a common foreign and defence policy is welcome. Provided that the EU does not seek to develop a military muscle and speak with a single voice specifically in order to spite the United States, and provided—more importantly—that nervous or dissenting countries are not bullied into accepting policies they dislike, building a beefier Europe with a global reach of its own is fine.

But, judging by the latest version, the drafters have displayed a worrying appetite for integration for its own sake—in a host of areas. Apparently in deference to the twitchy British, the word “federal” is to be dropped from the constitution's very first article, yet the more meaningful demand for “ever closer union”, implying just that impulse towards European statehood, is now in the preamble. More specifically, in their laudable desire to tackle cross-border crime, the drafters have over-enthusiastically suggested the creation of a “European public prosecutor”, thus encouraging moves towards a common criminal law—an integrationist step distinctly too far. Not only have the drafters insisted (as, admittedly, they were expected to do) on inserting a Charter of Fundamental Rights, but they have included in it a clutch of social and economic “rights” that have no place at all in a constitution. Indeed, in a section on “shared competences” there are many areas (including, again, those concerning “social cohesion”) where the EU should really be kept out. Above all, that awkward but crucial notion known as “subsidiarity”, which was supposed to mean that countries run their own affairs except where it is patently necessary for the Union to intrude for the sake of efficiency, has been too feebly defined in the new document.

Ah yes, say the worldly-wise of Brussels. But most of the EU powers articulated in the draft are already in force. Besides, Europe is about deal-making, about fudge and smudge, about warm exhortations meaning nothing precise. But the trouble with constitutions is that they must mean exactly what they say. They are justiciable, as indeed are current EU treaties; for the judges interpreting them, precision is everything.

A useful constitution can and should still be drawn up. The one emerging should be unacceptable, not just to British nation-staters but to all Europeans who want the EU—not only its free-trade machinery—to work well. But there is plenty to play for. A year of vigorous debate is likely to ensue. And if, in roughly its present form, the constitution fails to be ratified, too bad. Some countries may wish to rush ahead into a tighter union. Others may have to consider whether they want to stay in the club—or even seek a different sort of membership. A bad constitution would be worse than none at all.

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Letters

May 29th 2003
From The Economist print edition

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FAX: 020 7839 2968 E-MAIL: letters@economist.com

Vouchsafe?

SIR – You repeat the widely held belief that vouchers will help those students most in need to flee failing schools ("The mayor throws a lifeline", May 10th). The best empirical evidence flatly contradicts that claim. In the early 1990s, under an ambitious plan called Tomorrow's Schools, New Zealand gave all local public schools complete operational autonomy and abolished attendance areas. Parents were granted the right to apply to any school in the country, including parochial schools. Vouchers followed students to their school of choice.

What followed serves as a cautionary tale for cities contemplating voucher schemes. The best schools quickly filled and turned away students that were hard to teach—disproportionately poor and minority pupils. Students who were rejected had nowhere to go, except back to their schools of origin. These became significantly more polarised along socioeconomic and ethnic lines. In recognition that its grand experiment was not working, New Zealand began to pull back in the late 1990s. The country is still trying to pick up the pieces.

Walt Gardner
Los Angeles

No transfer of nukes

SIR – You allege unfairly that "Pakistan helped North Korea develop secret uranium-enrichment technology for its nuclear programme, and may also have helped Iran" ("Getting warmer", May 10th). You do not mention that the government of Pakistan has categorically, vigorously and repeatedly denied this allegation. Let me reiterate Pakistan's scrupulous adherence to the policy of non-transfer of nuclear technology or materials to other countries. This cardinal principle of state policy is embedded in the strict export-control regime regarding sensitive technologies.

Pakistan's record in this regard is impeccable. I draw your attention to a statement by a spokesman of the United States State Department on April 1st 2003 in which he stated categorically that "we have informed Congress on March 12th that this administration had carefully reviewed the facts relating to the possible transfer of nuclear technology from Pakistan to North Korea and decided that the facts do not warrant the imposition of sanctions under applicable US laws."

Your suggestion that Pakistan should be forced to renounce cross-border terrorism across the line of control is indeed unfortunate as Pakistan's efforts to combat terrorism have been universally acclaimed by important world leaders and the international media. Pakistan initiated the campaign against terrorism well before September 11th by banning extremist religious organisations. The events of September 11th only spurred my government to take further measures to curb terrorism. On several occasions, Pakistan has offered stationing of impartial observers on both sides of the line of control and a strengthening of the presence of the United Nations Military Observer Group in India and Pakistan to ascertain the veracity of the recurring allegations against Pakistan.

Abdul Kader Jaffer
Pakistan high commissioner
London

Priming the pension pot

SIR – Your assertion that the main reason for the recent shift from surplus to deficit of corporate pensions is the prolonged bear market in equities is only partially true ("Nest eggs without the yolk", May 10th). Liabilities have risen substantially because the rate at which they are discounted has fallen steeply in line with interest rates. The experience of one large British-based pension fund is informative: in the five years to 2002 its assets fell by only 4% because of its sensibly diversified portfolio, but its liabilities rose by 48% over the same period. There is no asset class that has returned that level of performance; certainly not bonds.

Pension-fund trustees would be wise to consider the experience of one of America's 25 largest firms before contemplating a wholesale shift away from equities. Starting with $100m 50 years ago and after just $6 billion in contributions, its pension fund has paid out $30 billion in benefits and has assets of $40 billion. While these figures are nominal, this performance is remarkable and could never have been achieved with a portfolio invested only in fixed-income assets.

John Webster
Greenwich Associates
Greenwich, Connecticut

Countering counterfeit

SIR – Your article on counterfeiting fails to mention the lucrative business of infringing the copyright on books ("Imitating property is theft", May 17th). Shortly after the second world war both Japan and Korea were engaged in the wholesale copying of American scientific texts and journals, something the Russians had been doing for years.

My father-in-law, then president of a well-known scientific publishing firm, went to Japan on behalf of a number of prominent American publishers and was able to convince the Japanese government that the practice was giving the country a bad name. The practice ceased. To my knowledge no American author ever received proper royalties for books copied by the Soviet Union in those years.

Hans Wynberg
Groningen, The Netherlands

Integrate or isolate

SIR – Multiculturalism per se is not to blame for the failure of Muslims to integrate into Britain; other minorities have used it to find a niche for themselves ("Forget asylum-seekers", May 10th). The problem lies in its misuse.

Hindus and Sikhs have used it to cultivate a composite British-Asian identity, looking inside society for political and cultural guidance. Muslims combine their presence in Britain with adherence to a supranational community, the Muslim *ummah*, looking outside—and thereby isolate themselves.

Randhir Singh Bains
Gants Hill, Essex

Systems failure

SIR – The failure of IT projects is rightly attributed in your survey to the abdication of responsibility by both IT "bosses" and "business units" (May 10th). Developing an IT system is like the production of *The Economist*. If the editor kept changing his mind about the front cover at the last minute, your newspaper would fail. This is typical of the way IT developments are run: managers change their minds about the system, requiring code rewrites resulting in the introduction of new bugs, and blown budgets and deadlines.

Why does this happen? Either managers do not know their own business and how an IT system should support it or the project becomes a managerial virility symbol that envious managers of other units sabotage by interference—inadvertently or deliberately. The success of projects and quality of IT systems depends on management throughout an organisation, not just in the IT department.

Martin Berridge
London

SIR – You suggest that Moore's Law follows a pattern of exponential growth. The law predicts that transistor density will double every 18 months. This is measly quadratic growth.

Frank Scheelen
Eindhoven, The Netherlands

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Weapons of mass destruction

Casus or casuistry?

May 29th 2003
From The Economist print edition

Where—if they existed—are Saddam Hussein's weapons of mass destruction?

GUNS normally smoke after they are fired. Had Saddam Hussein used his alleged weapons of mass destruction (WMD) during the American-led war that dislodged him, the doubts about his illegal arsenal would have evaporated. Yet despite all the talk of “red lines” around Baghdad, the sweaty protective suits in which American and British troops laboured were never put to the test. No Iraqi Scuds struck Israel or anywhere else.

These omissions at first seemed part of a larger mystery, namely why Iraq put up so shambolic a fight. But the ongoing elusiveness of the fabled “smoking gun” has led even those who supported the war to ask whether the WMD that in theory provoked it ever really existed—and whether the “proof” adduced by those who waged it was shoddy, or worse.

Down memory lane

Conspiracy theorists should remember that much of the evidence against Mr Hussein came not from the American and British governments or their spies, but from two unimpeachable sources. They were the United Nations weapons inspectors, and Mr Hussein himself.

Mr Hussein had what police call form. He made and used chemical weapons in the 1980s. Throughout the 1990s, he strove to hide his WMD programme from Unscom, the UN inspectorate then responsible for dismantling it. In this endeavour he enjoyed much success, though Iraqi defectors helped the inspectors to uncover, among other things, the extent of Iraq's biological weapons programme, and its manufacture of VX, a nerve gas. On the basis of Iraq's known imports and discrepancies in its record-keeping, Unscom and UNMOVIC (the latter-day inspection body, led by Hans Blix) made some frightening calculations about the chemical and biological agents and munitions potentially at Mr Hussein's disposal. On the eve of the war, UNMOVIC reported a “strong presumption” that around 10,000 litres of Iraqi anthrax might still exist.

Mr Hussein's form continued until the end. His regime failed to co-operate with Mr Blix's team in the way that UN resolution 1441, passed last November, demanded. Some Iraqi scientists refused to be interviewed privately, and the names of others were withheld, along with important documents. Though Iraq made some concessions, going so far as to destroy some proscribed missiles, its compliance with

resolution 1441 remained lacklustre. This recalcitrance, as America and Britain now sophistically aver, was the legal pretext for the war.

Sophistically, because the resolution was premised on the notion that Mr Hussein's WMD constituted an imminent threat to his region and to the world. The inspectors' accumulated findings, and Mr Hussein's own behaviour, certainly suggested that he was a menace. But George Bush and Tony Blair went further than the speculative conclusions of Unscom and UNMOVIC, whose reports were always a little too recondite to sway the masses.

Mr Bush and Mr Blair argued that the threat was imminent, adding some specific and alarming allegations. Unusually, and to the discomfort of British spooks, Mr Blair published an intelligence dossier that claimed some of Iraq's WMD could be ready within 45 minutes of an order to use them. Mr Bush eschewed the subjunctives that punctuated the inspectors' reports: citing American intelligence, he stated that Mr Hussein retained hideous agents and various means of delivering them. In February, Colin Powell, Mr Bush's secretary of state, told the UN that biological warheads had been distributed across western Iraq.

Surprising, then, that despite the efforts of America's own inspection teams, no actual WMD have been unearthed: none. It is especially surprising that those weapons which, according to intelligence reports, had been deployed to southern Iraq for use against the invaders haven't been found. There are plausible explanations for why Mr Hussein did not use his WMD during the war: political considerations, the pace of the American advance, and so on. But it would be very odd if he hadn't at least made some of them ready, assuming he had any. Raymond Zilinskas, a former inspector, says Mr Blair's infamous 45-minute claim “now seems close to absurd”.

In fact, the only important finds thus far have been what the Americans say may be three mobile biological-weapons laboratories, two of which are said to correspond closely to the sort described by Mr Powell, on the basis of reports from defectors, in his seminal presentation to the UN. After a series of “false positives” in their search for WMD, which have circulated as swiftly as did some battlefield rumours before being embarrassingly scotched, the Americans have been understandably cautious in their claims about the mobile labs. Still, they are convinced that they could have had no other, innocent purpose. On the other hand, no actual biological agents have been detected in the suspect vehicles.

Scud in a haystack

What of the thousands of bombs and warheads and tons of deadly agents that Mr Hussein was allegedly hiding? There are various possible explanations for their invisibility. One is that the American-led teams that have been nosing around Iraq haven't done a very good job, perhaps because they lack the expertise of the specialists led by Mr Blix. The unit responsible for the initial snooping is now being superseded by a bigger outfit, on to which some former UN inspectors are being co-opted. Another excuse is that many of the documents that might have helped the Americans to refine their search have been destroyed by looters. Some are said to have been incinerated by Saddamite loyalists, anxious to conceal their guilt and discredit their conquerors.

The most frequently cited argument is that the job requires more time. As British and American leaders are fond of saying, Iraq is approximately the size of France or California. This, combined with the ousted regime's expertise in concealment and deception, makes chance discoveries unlikely. In time, the argument goes, Iraqis in the know about Mr Hussein's WMD will be persuaded to spill the beans.

Unfortunately, not much spilling seems to have been going on so far. “Mrs Anthrax”, “Dr Germ”, and several of the other scientific and military henchmen on the Americans' list of most-wanted Baathists are in their custody. But they seem to be sticking to their pre-war story that Iraq was innocent and misunderstood. The line now emanating from Washington and London is that the “most wanted”, being anxious about prosecutions and reprisals, are not quite so wanted after all. Clues about the WMD are now expected to come from lower-ranking scientists, many of whom, it is said, are still too fearful of a possible Baathist resurgence to come forward, despite the rewards and incentives being proffered to them. Terence Taylor, another former inspector, agrees that middle-ranking scientists can be more revealing than their bosses.

But the idea that large stocks of, say, chemical shells can't be located without further tip-offs doesn't quite wash. Gary Samore, of London's International Institute for Strategic Studies—which produced an influential assessment of Iraq's WMD shortly before the British government issued its own—concedes that

if Iraq had retained large stocks of chemical munitions, they probably would have been found by now. And the chances of finding such caches could well deteriorate rather than improve with time. Ongoing looting will erase more paper trails. Information from captives and defectors is notoriously unreliable, given their tendency to tell interrogators what they want to hear; their claims will have to be laboriously cross-checked. If the leads they are said to be generating continue to disappoint, there will be nothing for it but to “look under every rock, go to every crossroad, peer into every cave for evidence” (Mr Powell's description of what UNMOVIC wasn't supposed to do).

Meanwhile, in an inversion of their rhetoric before the war, the governments that waged it have been massaging down expectations. MI6, Britain's foreign intelligence service, remains confident that the central tenets of Mr Blair's dossier will eventually be vindicated. But the politicians are hedging.

They are talking about piecing together evidence about a WMD programme from scientists and documents, rather than uncovering the weapons themselves. Some have speculated that the programme may have been dispersed to hide it from the inspectors (though this suggests that inspection was containing the threat). Some have hypothesised a “just-in-time” system of production to explain why no stocks have been discovered. Another idea, advanced by (among others) Donald Rumsfeld, America's defence secretary, is that Mr Hussein destroyed his WMD before the war—a baffling move for a hitherto unscrupulous regime facing an existential threat.

The most obvious explanation is of course that, leaving aside the mobile labs, there are no massively destructive weapons or facilities in Iraq to find. This Occamite theory in turn raises two main questions. The first concerns Mr Hussein's own obstreperous behaviour. Why, if he had nothing to hide, did he subject his country to the crippling economic sanctions, periodic bombings and eventual invasion that his non-compliance with UN resolutions and inspections incurred?

There are several more or less plausible answers. The least subtle is that Mr Hussein didn't give a hoot about ordinary Iraqis and wouldn't countenance the loss of face that fully submitting to the UN would have meant. The most sophisticated is that he thought Iraq's strategic interest lay in cultivating a sense of ambiguity over its WMD efforts: intimidating his enemies, while denying them the evidence to prove his guilt conclusively. More likely, he had indeed maintained some sort of WMD programme, perhaps less advanced than Messrs Bush and Blair said, but sufficient to explain the shenanigans that plagued the inspectors. Whatever Mr Hussein's strategy, it backfired catastrophically when he underestimated Mr Bush's resolve to get rid of him.

Doctored

The second question, which should be easier to answer regardless of whether or not the gun eventually smokes, is: how and why did Britain and America come to make what now looks like an exaggerated case for war? Parts of the case were always dubious. Another dossier released by Mr Blair's office, purporting to detail Iraq's intelligence infrastructure and praised by Mr Powell at the UN, turned out to have been partly plagiarised from a graduate student and stitched together by spin-doctors. Efforts to connect Mr Hussein with al-Qaeda always looked thin. Now the intelligence used to elevate the threat of Iraq's WMD from long-term and tolerable to imminent and actionable also looks ropy.

Among the specific questions that require answers are how, as seems to have been the case, forged documents came to be used as proof that Iraq had tried to buy uranium for its alleged nuclear programme from Niger. (British sources, by the way, insist that other, non-forged documents prove that Iraq tried to do just that in the past few years.) How influential and reliable was a special office created in the Pentagon to revisit Iraqi intelligence? Was information from defectors properly vetted? Did the CIA adequately counteract the wilder claims emerging from other intelligence agencies? Ken Pollack of the Brookings Institution, who was a leading advocate of deposing Mr Hussein, thinks that some officials may knowingly have used weak evidence to build their case. A review of Iraq-related intelligence and how it corresponds with reality, which Mr Rumsfeld has asked the CIA to conduct, must resolve these pressing issues.

Still, given all the evidence available, it remains likeliest that Mr Hussein did indeed have some sort of WMD programme, if not the serried ranks of illegal munitions portrayed by Mr Blair and Mr Bush. So another, equally pressing question requires an urgent answer: where is it?

After repeated, ignored warnings to the Americans, a team from the IAEA, the nuclear inspectorate, is imminently to revisit Iraq to assess the possible loss and looting of radiological material from its main

nuclear centre. But chemical and biological kit and agents may also have gone astray. So, just as importantly, may some of the scientists who designed them. Some material and boffins may have left the country—perhaps to Syria, as intelligence reports have suggested. Some may still be in the hands of die-hard Baathists. As the CIA once warned might happen if Iraq were attacked, some may even have fallen into the hands of terrorists. The bungled hunt for Iraq's WMD could yet turn out to be worse than an embarrassment.

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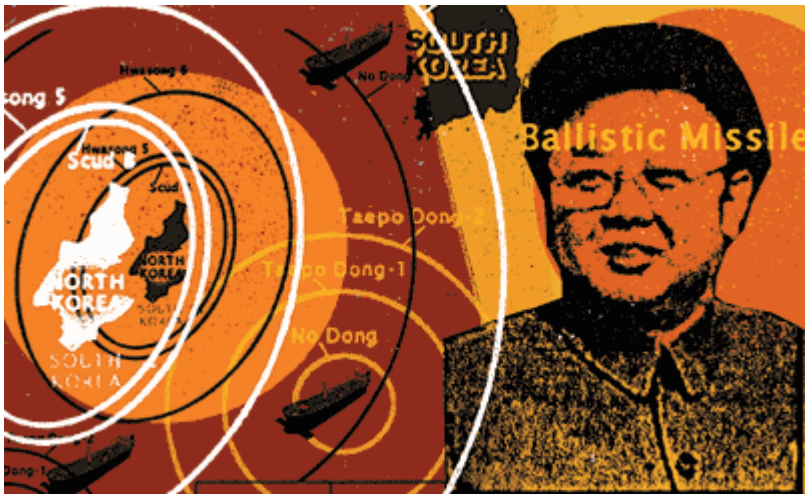
Proliferation

After Iraq

May 29th 2003
From The Economist print edition



America weighs its options for dealing with other rogue states

Get article background

NOW that the fighting in Iraq is over, what does George Bush have in mind for the rest of the “axis of evil”? Undaunted by the failure, so far, to find Saddam Hussein's weapons of mass destruction, he continues to emphasise his determination not to permit “the world's most dangerous regimes to threaten us with the world's most destructive weapons”. This aim and the means to achieve it were codified last year in a new national-security strategy, which gave warning that America might act “pre-emptively”.

Officials of all stripes in the Bush administration insist that America is not looking for another country to invade. Their handling of North Korea—refusing to rule out the use of force, but trying to resolve the issue multilaterally—bears this out. The military pre-emption Mr Bush envisages, they say, is more about having the right sort of intelligence to forestall a terrorist or other imminent attack.

Intelligence aside, Iraq is regarded as singular and no template for future American action. Yet the administration certainly intended the war to send a message—namely “that we will move very vigorously to prevent the acquisition of nuclear [and other] weapons,” as one noted hardliner puts it. Just as important in deciding how all this plays out, adds a colleague, will be whether other governments make fighting proliferation a priority.

In the Middle East the network of treaties banning nuclear, chemical and biological weapons was always threadbare, with Israel outside the Nuclear Non-Proliferation Treaty (NPT), and most other governments outside the Chemical Weapons Convention. Iran has signed both, and is suspected of secretly breaking both. But the toppling of Saddam Hussein, argue American officials, has changed things. It should be seen as a salutary lesson but also as an opportunity for Iran, especially, and also Syria and Libya, to rethink their security and stop acquiring weapons of mass destruction (WMD)—though few suppose they will take it.

But the fate of Iraq points the other way, does it not? North Korea used its inclusion in Mr Bush's “axis of evil” and the outcry over the Iraq war to justify rejecting international inspections and to step up its nuclear claims and threats. And if Iran has weapons ambitions, won't it now redouble its bomb-building efforts? America was evidently readier to use force against Iraq, which had no bomb, than against North Korea, which claims to have two.

American officials see it differently. Reluctance to use force against North Korea, they say, is not because of the bomb in its basement: Seoul, South Korea's capital, has long been in range of North Korean guns. And this reluctance has its limits, depending on what North Korea now does to threaten the region or to export its nuclear booty. The lesson of Iraq for North Korea, says one official darkly, has yet to be fully played out. The more determined Iran seems to build a bomb, adds another from the more multilateralist camp, the greater will be the pressure to act against it.

Force is an option and must remain so, says Michael Krepon of the Henry L. Stimson Centre, an independent think-tank in Washington, DC. But if Mr Bush overplays the military instrument, the result, Mr Krepon argues, will be “war without end, and without friends”—something that some administration officials show fewer signs of caring about than others. What America needs, says Mr Krepon, is a broader strategy for co-operative threat-reduction, It should work with other governments, using incentives and not just punishment, to encourage other would-be proliferators to see their security better served in other ways; and it should use diplomatic and economic tools, as well as military ones.

Mr Bush's officials would agree. In a follow-up to the national security strategy last September, they laid out a more detailed policy for opposing the spread or use of WMD. In it Mr Bush reserves the right (as other presidents before him) to respond with “overwhelming force—including through resort to all our options” to use of such weapons against American territory, forces or friends. The document also underscores the need for active defences, including missile defences, and for possible pre-emptive measures. But in its less well-read parts, it also calls for greater national and international efforts to improve intelligence, to strengthen the treaties and supplier cartels that seek to restrict trade in the most sensitive materials, to reach new agreements where needed and to improve export controls and sanctions.

The trouble, argues Douglas Feith, a Pentagon hawk, is that when talk turns to prevention and pre-emption, others tend to focus on the most sensational elements of the administration's strategy. But America, he says, will use a range of policies to deal with different proliferation threats, from diplomatic and economic pressure, to the possible interdiction of suspect cargoes, to “other steps”, including the kind of action taken in Iraq. The more support there is for early-resort measures, “the less one needs to think of war”. One way or another, though, America will keep the anti-proliferation pressure on.

A fine example

Critics say that Mr Bush's team is partly to blame for declining confidence in the treaties that were meant to block the spread of WMD. New research money for low-yield nuclear weapons is part of Mr Bush's budget request to Congress. Or take the refusal to support a test-ban treaty; or America's rejection of efforts to add a checking mechanism to the convention banning biological weapons. The administration is putting no real pressure on Israel, India and Pakistan, three NPT hold-outs and de facto nuclear powers which are its friends, while piling the pressure on Iran and North Korea. This makes it harder to uphold the anti-proliferation line elsewhere. Also, the focus on “bad regimes” feeds the suspicion that remaking the world by force, not tackling proliferation, is the administration's real purpose.

Mr Bush's officials are unabashed. John Bolton, who leads the State Department's anti-proliferation warriors and is famously reluctant to see America tied down by new international treaties of any sort, insists that the treaties dealing with nuclear, chemical and biological weapons need to be better enforced. More than once he has named the countries America believes are cheating. At a recent huddle of NPT members, America's diplomats argued that rule-breakers should expect to face “serious consequences”.

In 1992 the UN Security Council issued a statement calling the spread of WMD a threat to international peace and security. North Korea's recent antics have led some officials to consider going back to the UN for more specific authority to impose sanctions and other measures. One useful step, suggests Robert Einhorn, a former Clinton administration official now at the Washington-based Centre for Strategic and International Studies, would be for the council to authorise the boarding of North Korean vessels and aircraft suspected of carrying weapons or weapons-related materials into or out of the country.

Some of Mr Bush's team would rather work alongside like-minded governments. Whatever the mechanism, the idea would be to disrupt the extensive secondary trade that takes North Korean missiles to Pakistan, Iran, Libya, Syria and elsewhere, and which enabled Pakistan to pay off part of its missile debt by helping North Korea with its uranium enrichment. No one wants to repeat the recent embarrassment when a Spanish warship, at America's request, stopped a North Korean vessel carrying a hidden cargo of missiles (bound for Yemen, it turned out). With no legal basis for interrupting North

Korea's proliferation habits, the cargo had to be allowed on its way.

Henry Sokolski, of the Non-Proliferation Policy Education Centre, would like to see it made illegal to send WMD from one country to another. Suspect cargoes could then be inspected by any UN member, anywhere. This rule would also prevent, say, Pakistan from stationing any of its nuclear weapons in Saudi Arabia (theoretically legal, so long as they remained under Pakistani control)—an idea reportedly mused about in the past.

Worse than blatant

North Korea is difficult, but administration officials admit that Iran may pose the bigger challenge. First, its government shows no sign of reining in its nuclear programme. Second, Russia and the European Union are keen to keep trading with it; Russia is building a nuclear power plant at Bushehr. Third, though with much the same effect in the end, Iran may bend the rules rather than blatantly break them.

Under the treaty, it is perfectly legal for a country like Iran to have uranium-enrichment and other nuclear facilities, as long as these are under safeguards and not intended to make weapons. But Iran does not need its enrichment facilities for Bushehr, since the Russians have agreed to handle the reactor fuel. Nor does it need its heavy-water production plant for a civilian programme based on light-water reactors; these would, however, be very useful for bomb-building. These issues will surface next month, when the International Atomic Energy Agency, the UN's nuclear watchdog, reports what it found during visits earlier this year to some—but only some, others were still off-limits—of Iran's nuclear facilities.

At the recent NPT gathering, America proposed an end to nuclear trade with countries who fall under suspicion, even before they have been found formally in non-compliance. Russia is unlikely to agree to this. The EU says it will use its current trade discussions with Iran to press for a programme of stronger nuclear safeguards. Too little, too late, argues another former Clinton administration official. Iran can keep within the NPT's rules, while developing all the skills and expertise it needs for a sudden break-out—and three months' notice of withdrawal is all the NPT officially requires.

Renegotiating the treaty to close such loopholes looks impossible, and would anyway be too late for Iran. A plausible alternative—offering Iran a deal to give up its enrichment programme—has other drawbacks. It could seem to reward treaty-bending. And what if Iran, like North Korea, cheated on regardless?

In the end, say Mr Bush's officials, those determined to build weapons of mass destruction will do so unless they are stopped. When other policies have failed, there may be no choice but to seek to change the nature of the regimes, or the regimes themselves. Does anyone have a better answer, they ask?

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George Bush goes to Europe

On the road again

May 29th 2003
From The Economist print edition

Reuters

If Europeans want to understand the way the president's mind works, they should look at his tax cut as well as his diplomacy

Get article background

DOES the Bush administration have an unspoken plan to stomp on all the traditions of polite society to force through radical changes in tune with conservative ideology? The question is usually applied to foreign affairs, where the president is routinely criticised for trashing traditional alliances. But it might be applied with equal force to domestic economic policy.

As *The Economist* went to press, the president was set to begin his first trip to Europe and the Middle East since the transatlantic rift yawned wide over Iraq. His audience will find out how far he is willing either to bind up the wounds of that episode, or to twist the knife in further.

Most of the signs are that the president will at least try not to make matters worse. In an unusual example of diligent diplomatic preparation, he struck a deal on post-conflict Iraq at the United Nations Security Council with the three main refuseniks—France, Germany and Russia. And, in a move that astonished both his allies and his critics, he first put pressure on Israel to accept the Middle Eastern road map, and then called summits with the Israeli, Palestinian and other Arab leaders.

Yet in terms of understanding how the administration really works, at least as much can be learned from the event that preceded George Bush's trip, his signing into law of his second big tax cut in two and a half years (and his third cut overall). Behind domestic policy no less than foreign policy sits the same sort of questions: is Mr Bush merely a short-term opportunist, cutting taxes when he can, just as he is often accused of disposing of treaties at will? Or is there a bigger longer-term strategy—such as reforming America's tax system (or reordering modern diplomacy)?

In the case of the tax cut, there are plenty of signs pointing straight towards opportunism. The idea of tax reform is largely associated with Mr Bush's first, discarded, economic team. In the early days of the administration, the treasury secretary, Paul O'Neill, argued for a greater emphasis on tax reform, along the lines of Ronald Reagan's tax package of 1986, which cut rates and broadened the base, without reducing the overall burden. The first White House economic adviser, Larry Lindsey, was a tireless advocate for a simpler, flatter tax system. The chairman of the Council of Economic Advisers, Glenn

Hubbard, wrote papers extolling the virtues of a consumption tax, in place of traditional taxes on income and capital.

All three reformers have left the administration. In 2001, when he gave back $1.35 trillion over the next ten years, the president put more effort into cutting taxes than reforming the structure; and he has done so again with the new $350 billion tax-cut package. Mr O'Neill's study of tax reform has been buried. On the stump Mr Bush never ceases to sing the praises of lower taxes. He has not spelled out a case for reform, as Ronald Reagan did in 1986.

Moreover, in one respect the new tax cut marks a step away from reform and simplicity. To squeeze Mr Bush's cuts into that $350 billion number, Congress made sure that all but one of the bill's provisions are supposed to be reversed ("sunsetted", in the jargon) between 2004 and 2008. The child tax credit is supposed to change four times between now and 2010.

Mr Bush can point out that this manoeuvring has more to do with the negotiations between the House of Representatives and the Senate than the White House's more coherent initial proposal. All the same it is precisely the type of gimmickry that tax reformers hate. The sunsets are bad in themselves, since they complicate individual financial planning (no one will know what their taxes will be from year to year). Worse, they disguise the real costs, because in practice politicians will not want to reinstate the current rates.

According to the Centre on Budget and Policy Priorities, if all the provisions become permanent (not an unreasonable assumption), lost revenue will amount to $800 billion-1.1 trillion over ten years—almost as big as the 2001 tax cut. And this time, the administration cannot claim there are budget surpluses to pay for it.

All this makes the new tax cut look opportunistic, confused and reckless. Yet there are also clear signs of a bigger plan at work. This takes two forms.

First, tax reform, though rejected as a systemic overhaul, has crept in through the back door as incremental change. The tax cut of 2001 reduced the number of income-tax brackets from five to four. This week's law speeds up the introduction of that change (originally intended to be phased in). More important, the new package continues a shift away from taxing capital which began two years ago when he got rid of inheritance taxes (at least till 2011). This time he tried to eliminate the double taxation of dividends. In the end Congress roughly halved it.

There are also plenty of signs that the administration is not finished. This year's annual Economic Report to Congress scathingly criticised the traditional tax system and sung the praises of a consumption tax. The budget originally proposed a huge expansion of tax-advantaged savings accounts, though the idea was shelved. Grover Norquist of Americans for Tax Reform, a group close to the administration, says Mr Bush wants more tax cuts next year.

Second, Mr Bush seems to like tax cuts not just for their own sake, or in order to win elections (and in fact public support for tax cuts is modest). Rather, he seems to see them as part of a broader conservative plan to reduce the size of government.

Mr Bush seems to have bought wholesale the idea of "starving the beast" (a phrase of President Reagan's first budget director, David Stockman). He wants to force the government to rein in spending by reducing its tax revenues. Mr Bush has never made this argument explicit, but this year's budget proposal included a table showing that discretionary government spending ("Bigger Government") soars during budget surpluses. The implication is that spending will fall if the budget is in the red. As Allen Schick of the University of Maryland puts it, Mr Bush "wants to strip the government of future revenue not in spite of these dire [budget] scenarios but because of them."

The only trouble is there is no sign that the policy is working. Discretionary spending has been rising for several years. It currently accounts for 3.5% of GDP. But that figure is tiny once you start looking for ways to pay for tax cuts. According to Peter Orszag of the Brookings Institution, if all this year's tax cuts go into effect, they will be the equivalent of 2.4% of GDP in 2013. To find that amount from discretionary spending, you would have to cut it by two-thirds—an impossible task seeing so much of it goes on policing and homeland security. Mr Bush's giveaways will have to be financed eventually by slimming the much bigger entitlement programmes.

Unfortunately, Mr Bush is talking about increasing spending on entitlements. To bribe states into

accepting caps on federal contributions to Medicaid, the health-care system of the poor, he is offering larger up-front initial payments. He wants to offer a prescription-drug benefit as part of the Medicare system for the elderly—a classic case of offering the sugar coating without the pill of reform. And he still seems worried by the cost of changing the biggest entitlement of all, Social Security. At the moment it looks as if Mr Bush is leaving the tougher bits of “starving the beast” to his successors.

Redrawing the map

As he arrives in Europe, his audience might ponder the parallels between this fiscal story and his approach to foreign affairs. The style is the same. There is the same emphasis on the personal leadership of Mr Bush, whether he is pushing regime change or tax cuts. There is the same tendency to treat allies—in Congress or Europe—as mere followers.

Yet lurking behind Mr Bush's diplomacy, no less than his fiscal policy, there is the same radical desire to redraw the map and the same willingness to act disruptively to advance that end. Just as Mr Bush plainly wants to junk parts of the current tax system, so he is prepared to dispense with many traditional alliances or international treaties. Just as he is prepared to ignore the howls about the deficit, because he thinks it will force smaller government, he also thinks that diplomatic conflict will force Europeans to reconsider their view of the world.

This mixture of opportunism and radicalism has its attractions. But there is one final parallel that Mr Bush's hosts in Europe might want to push him on. What happens if his broader ambition starts to go awry? That is already happening with entitlement reform. Abroad, it is to be hoped that he will not shirk the task of rebuilding Iraq and driving forward the Middle East peace process.

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George Bush and the peace process

Like Nixon to China?

May 29th 2003 | WASHINGTON, DC
From The Economist print edition

When it comes to American Jews and the Middle East, the president has more room for manoeuvre than you might think

ON FEBRUARY 26th, George Bush addressed the annual dinner of the American Enterprise Institute, a neo-conservative think tank, on the subject of democratising the Middle East. The audience could hardly have been more enthusiastic until he touched on the subject of Israel. Then the mood suddenly changed. Many of America's leading Jewish intellectuals sat in stony silence as the conservative-in-chief made the case for a “viable” Palestinian state and for ending settlements in the occupied territories.

Does this stony silence presage trouble for Mr Bush in the future? Does he risk alienating Jewish voters if he pushes forward with his road map for peace in the Middle East? And will fear of alienating those voters force him to adjust his policies? The encouraging answer to all three questions is that he has far more freedom to be bold than many Europeans imagine.

Mr Bush can hardly worry much about alienating the Jews since the overwhelming majority of them vote Democratic. Exit polls in 2000 suggest that 79% of Jewish voters voted for Al Gore compared with just 19% for George Bush—a remarkable figure considering the average income of the Jewish community. The White House would clearly relish attracting more Jewish voters, particularly in the vital swing state of Florida. But, overall, Jews account for only one in 50 Americans, and most of them live in two Democratic fortresses, California and New York.

It is also a mistake to assume that America's Jews are any more solidly behind a neo-conservative hard line in the Middle East than Jews in Israel are. One poll conducted last July (on behalf of the American Jewish Committee) found that 63% of American Jews favour the establishment of a Palestinian state. Another poll conducted last November (on behalf of the Arab American Institute) put the portion at 87%; it also showed that most American Jews want the American government to be seriously engaged in the peace process.

Mr Bush's new initiative in the Middle East is already garnering strong support from influential Jews. On May 19th 100 prominent figures with close ties to the Democratic Party sent a letter to the Democratic presidential candidates urging them not to criticise the road map.

That still leaves those more conservative Jews of the sort gathered at the AEI dinner. Hardliners tend to be to the fore in the main lobbying groups such as the American Israel Public Affairs Committee (AIPAC). There are also those much-analysed neo-conservatives gathered around Mr Bush. Unlike AIPAC, they loathed the Oslo peace accords, and they provide much of the Republican Party's intellectual input, particularly on foreign policy. Surely these conservatives will redirect Mr Bush from his current course?

The trouble with this argument is that these conservatives are boxed in. Most neo-conservatives have strong institutional and personal ties to the Bush administration. AIPAC has been well treated by the Bush administration so far. It would be hard to turn against the conqueror of Baghdad without looking churlish.

And where else can they go? The Democrats are substantially more pro-Palestinian than the Republicans. In May last year 44 House Democrats (including five senior ones) voted either “no” or “present” on a broad pro-Israeli motion compared with just six House Republicans.

Mr Bush's very closeness to so many Jewish conservatives may help him sell his peace plan to his toughest potential critics. Mr Bush's senior adviser on the Middle East is Elliott Abrams, a neo-conservative firebrand who has previously praised Ariel Sharon for his “strength” and “firmness” towards

the Palestinians. Of course, Mr Abrams's appointment may show that Mr Bush is not really serious about his road map. But it may also strengthen his hand when it comes to negotiating with reluctant right-wingers in Israel.

Richard Nixon was able to go to China because his anti-communist credentials were so strong. Mr Bush's pro-Israeli credentials arguably give him greater freedom in the Middle East than any Republican president has previously enjoyed.

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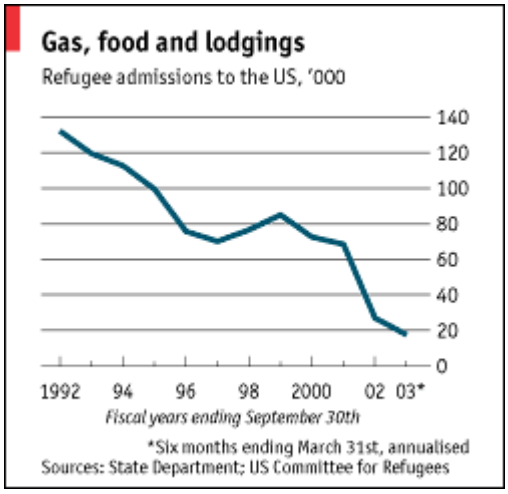
Refugee policy

A home at last, but not for many

May 29th 2003 | CHICAGO
From The Economist print edition

Can America's refugee policy be reinvigorated?



EARLIER this month, the first trickle of Somali Bantu, a group of rural Africans who have never experienced electricity, flush toilets or telephones, began arriving in places like Phoenix and Salt Lake City. Over the next two years, 12,000 Bantu are due to settle in up to 50 cities and towns across America. If integration sounds a challenge, consider what they have been through: persecution in their homeland, civil war, a decade languishing in refugee camps, and the tragi-comic experience of being trucked across Kenya to meet American officials who dared not visit them.

This might seem to fit into the tradition of Ellis Island. In fact, America's refugee programme is in its worst state for two decades. A steady decline in new arrivals hit a full stop after the terrorist attacks of September 2001, and it has resumed at a trickle. A report from the US Committee for Refugees (USCR), released on May 29th says only 27,100 refugees arrived in America in the fiscal year ending in September 2002, compared with 68,400 in 2001. Last year the government had given approval for 70,000 arrivals. Of the 50,000 ceiling set for this fiscal year, only 8,800 had been admitted by the end of March, the half-year mark.

Terrorism accounts for part of the slowdown. Fear of another attack recently forced the American government to bring staff home from Kenya, a big refugee-processing centre. Under America's tougher new security regime, potential refugees who have come though their interviews with resettlement officers now face background checks by the FBI and CIA, both of which are inundated with other duties. The State Department says 30,000 applicants already interviewed abroad are awaiting security clearance.

Many of the hopefuls, like the Bantu, have spent years at camps in countries like Kenya and Saudi Arabia. Kathleen Newland, of the Migration Policy Institute, claims that refugees are now the most scrutinised people coming into the United States: “They even have case workers after they get here.”

There are, however, good reasons to check people carefully, even leaving aside terrorism. The authorities have uncovered plenty of fraudulent applicants in the family-reunification programme, especially from western Africa. For some countries, 60% of the affidavits written on behalf of relatives have been proved to be false.

Fewer people, more countries

There is also a structural reason for the sluggishness. In the past, American officials concentrated on processing large groups—like the Vietnamese or Soviet Jews. Now their work is spread out between more than 60 countries. This has pushed up costs. Before September 11th, the basic cost of resettling a single refugee was about $1,500 per person. Given the new constraints, the State Department reckons the best figure achievable now is about $4,000—and that depends on the pipeline flowing freely, which it is not.

The lack of refugees has left the resettlement agencies, which are paid by the government on a per-refugee basis, in a bind. The largest such agency, the US Conference of Catholic Bishops, settled over 16,700 refugees in fiscal 2001 but only 5,900 last year. The organisation, which works locally through

Catholic charities, is cutting back to cover a huge shortfall.

Over at the Chicago office of World Relief half the jobs have gone as the agency's budget has fallen from $3m in 2001 to $1.6m. It has also had to close a “microenterprise centre” that helped start 70 refugee-run businesses over two years, and a rehabilitation centre that helped disabled refugees. Dori Dinsmore says she would not mind this slowdown if it were caused by there being fewer refugees, but there are still vast numbers of displaced people around the world. This week's USCR report estimates there are 13m refugees, half of whom are Afghans and Palestinians.

The State Department insists the logjam is beginning to break. Around 2,500 refugees arrived in America in April, and 3,000 were expected in May—the highest monthly totals since the terrorist attacks of September 11th.

Meanwhile, Ms Dinsmore says resettlement agencies are less misty-eyed about how the American people see their clients. The agencies used to imagine that refugees were “the fuzzy teddy bears of immigration”, seeking democracy and fleeing persecution. After September 11th, they are more likely to be scrutinised suspiciously. The Somali Bantu still have some way to go before they become Americans.

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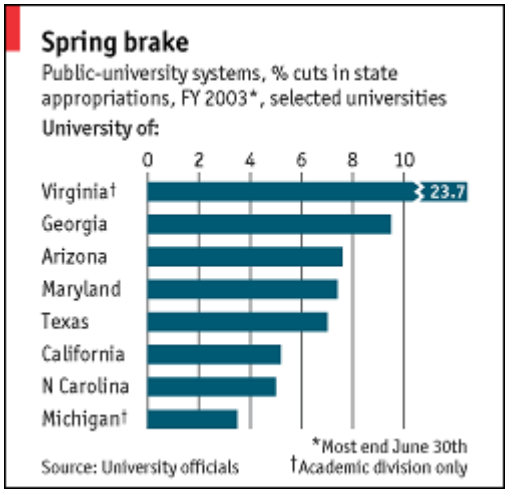
State universities

Remedial finance

May 29th 2003 | BERKELEY
From The Economist print edition

Public universities are another victim of the states' budget problems



STUDENTS at the University of California (UC) at Berkeley will protest about almost anything related to global politics. Their militancy might be better directed closer to home. Across the UC system, research projects and libraries are low on cash, and student health services and some classes have been scaled back. Gray Davis, California's cash-strapped Democratic governor, has cut $170m in aid to UC for the fiscal year ending in June.

That may seem small when set against the state's annual contribution of around $3 billion, let alone UC's total budget of $10 billion. But enrolment is rising fast, and as the headlines in the *Daily Cal*, Berkeley's student paper, make clear, worse is to come. Mr Davis wants to cut another $140m next year; and with the state still facing a budget shortfall of $20 billion or so, some harsher souls in the state legislature want to deprive UC of $400m more.

This story will be familiar to public universities across the country. The University of Texas at Austin is bracing for possible cuts of 10% in its state aid next year. At the 16-campus University of North Carolina, the state last year reclaimed nearly $60m in already-pledged money—and ordered another $200m in cutbacks.

Patrick Callan of the National Centre for Public Policy and Higher Education points out that state universities experience extremes of the economic cycle—pampered in good times, spurned when budgets turn red. During the 1990s state aid grew by around 60%. But this downturn is different, he says, because the number of high-school graduates is rising to a peak in 2009. UC is still adding a tenth campus in Merced, in the San Joaquin Valley.

Compared with their counterparts in Britain, America's public universities are reasonably diversified. At Chapel Hill, the University of North Carolina's flagship campus, only a quarter of the budget comes from state government. As state handouts shrink, the universities are turning even more to private sources.

Many are raising tuition fees—some by more than 20%—and wooing out-of-state students, who pay more than locals do. Law and business schools are particularly aggressive fundraisers; they are also pushing money-making courses such as executive education. Howard Frank, dean of the University of Maryland's Smith School of Business, says that state money now fills about a tenth of his coffers, against 50-60% five years ago.

A few politicians and professors are even rethinking the basics of public universities. Mitt Romney, the slash-and-burn governor of Massachusetts, has raised hackles in academia by proposing to privatise, in large part, three campuses at the University of Massachusetts, to revamp its Amherst flagship campus with money from more out-of-state students and—most heretically—to do away with the office of the university president (currently occupied by one of his political foes). Colorado recently rejected a higher-education voucher system.

Will this mean that state universities lose students and professors to their private competitors? Students tend to stick with state universities during hard times. The University of Connecticut, for instance, which is surrounded by rich Ivy League colleges, has reported a 28% surge in applications this year. Tuition

fees for locals at state universities may have crept higher, but they rarely amount to a quarter of the $25,000 or so a year charged by the cream of the private sector. State universities have also virtuously kept financial aid for poorer students in place.

Academics might be more tempted to drift away. A recent study found that UC professors earned about 7% less than their counterparts at comparable institutions (public and private) around the country, and the disparity is expected to grow next year. Still, as Mr Callan points out, faculty positions at private universities are hard to come by—not least because they are feeling the pinch too.

Donations to private universities fell last year for the first time since the late 1980s, according to the Rand Corporation's Council for Aid to Education. Their endowments have also shrunk with the stockmarket. In February Moody's downgraded the debt ratings of 11 private colleges. Stanford University, faced with a $25m shortfall next year, is freezing professors' salaries. That at least may give any protesters at Berkeley something to smile about.

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Drum circles

The rhythm goes respectable

May 29th 2003 | CHICAGO
From The Economist print edition

Now it's for corporate executives and old buffers too

AP

Drum major

SITTING in concentric tiers, they beat on their African drums into the early-morning hours. All eyes are on the woman in the centre, who gyrates to the rhythm wearing an outfit that is part punk, part belly-dancer: nose-ring, five-inch platform boots, ankle bells, black bodysuit, sequinned bikini top and a flowing pink skirt. It may sound like a California beach; but this is Rhythm, a warehouse-turned-club on Chicago's trendy near-West Side that shows the growing popularity of group drumming.

If the phrase makes you think of Grateful Dead concerts and drug-induced states of mind, think again. This is something pretty new. Drum circles have been around since the 1960s on the west coast, with its new-age culture. But in recent years the movement has pushed beyond its anarchist roots, drawing in old folk and corporate executives as well as the usual kids. Arthur Hull, a 53-year-old Californian who is considered the father of drum circles in America, says: “It no longer has the bad connotation of hippie thunder-drumming. This is family-friendly.”

Community drum circles meet in parks, coffee houses and local pubs. Cities sponsor drumming groups for teenagers. There is an accepted drum-circle etiquette (“Leave rhythmical space for other people to express themselves”) and terminology (“percussion puppies” should not tease a “rhythm dork”), all laid out in Mr Hull's book, “Drum Circle Spirit”. A key figure is the “facilitator”. This particular night, she is the funkiest person in the room: that gyrating lady at the heart of the drum pit. Otherwise, your correspondent is surrounded by clean-cut 20- and 30-somethings banging modified *djembe* drums.

A few young men sport earrings, sleeveless vests and rippling muscles, but most people look as ordinary as the fellow in shorts and hiking boots who says he has a senior job in a medical-products company. Mr Hull has put drum circles into corporate settings; his clients have included Apple Computer, General Electric, Motorola and Toyota.

Beyond the fun of getting together to make noise, enthusiasts say the benefits of group drumming include healing of both mind and body. Psychotherapists hold drum circles with aggressive juvenile sex offenders who respond to little else. A paper published by several doctors in 2001 claimed that group drumming, under the right conditions, can improve the body's immune response. John Yost, who leads drumming classes for the Chicago Park district, says “I've seen kids with Down's syndrome, severely autistic people; someone who can only drool becomes completely animated and can play with the beat.”

Mr Hull, who wants to take the drum movement to Europe, tries to be cautious. “This is a community-building process,” he says. “Even if you're not looking for any deep healing, religious or cosmic experience, when people get together, stuff happens.” Beat that.

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Arkansas politics

Swings and see-saws

May 29th 2003 | LITTLE ROCK
From The Economist print edition

The hard life of southern Democratic senators trying to please both sides

AP

Blanche: she does if you say "Holmes"

WHEN a group of about 150 leftish thinkers crowded into a Little Rock auditorium recently to talk about federal judgeships, some wag joked that they were the only liberals left in the state. Fearing this may be so, organisations such as the Sierra Club, the National Organisation for Women, the Alliance for Justice, Planned Parenthood and various trade unions are planning to pour money into the state. On June 4th, they will hold the first of a series of town-hall meetings this summer in Hot Springs to explain to Bill Clinton's home town why George Bush is too conservative, particularly when it comes to nominating judges.

This apparently broad attempt to sway the hearts and minds of Arkansas is actually aimed largely at two people. Senators Blanche Lincoln and Mark Pryor are in a familiar position for southern Democrats—trying to balance the leftish instincts of their party's main supporters with a state that is turning more conservative.

Last year, Mr Pryor had to emphasise his conservative credentials to beat the incumbent Republican, Tim Hutchinson. In recent years Mrs Lincoln, too, has sometimes broken away from the Democratic pack and voted with Republicans in the Senate. Back home in Arkansas, where she is up for re-election in 2004, she considers it a net plus to tell the folks she isn't swayed by one party or the other. Her voting record helps to impress conservative Blue Dog Democrats, whose votes she needs in order to win re-election.

Mrs Lincoln and Mr Pryor are part of a group of moderate southerners who are apt to see-saw on delicate issues such as the environment, abortion and tax cuts. When the Senate refused to allow oil exploration in the Arctic National Wildlife Refuge, Mrs Lincoln and Mr Pryor provided crucial votes. Mrs Lincoln voted for the 2001 tax cut, but against this year's one—even though the president came down to Arkansas to put pressure on her. Mr Pryor also voted against it.

At the same time, the pair are a target for indignant liberals, particularly on the subject of judicial appointments. The same groups who derailed Robert Bork's nomination to the Supreme Court and nearly succeeded with Clarence Thomas, are anxiously scrutinising the ageing bench again. They think that Mr Bush will have to nominate at least one justice—and they worry what Senators Pryor and Lincoln will do.

Mrs Lincoln and Mr Pryor have opposed Mr Bush's most controversial nomination so far, that of Miguel Estrada to the federal Court of Appeals for the District of Columbia. Yet both of them also commended another Republican nominee, Leon Holmes, at his confirmation hearing before the Senate Judiciary Committee earlier this year. Mr Holmes, an apparent kindly Southern gentleman type, briefly worked at the same law firm as Mr Pryor.

As a fierce opponent of abortion, Mr Holmes has always been unpopular with Democratic women's groups. However, since his hearing, some of his less gentlemanly writings have come to light. He has recommended that wives should submit to their husbands. He also wrote, some 15 years ago, that "the concern for rape victims is a red herring, because conceptions from rape occur with approximately the same frequency as snowfall in Miami." He has recanted these words; but it does not seem to have got him—or the two Arkansas senators—off the hook.

The newly elected Mr Pryor has plenty of time to accommodate the Democratic groups trooping round Arkansas this summer. But Mrs Lincoln may be gearing up for the fight of her political life. She is likely to

face either Mike Huckabee, Arkansas's Southern Baptist governor, or Asa Hutchinson, a former Arkansas congressman who is now under-secretary of the Department of Homeland Security. Both are attractive candidates for conservatives. The last thing she needs is to fight off a primary challenge from the left wing of her own party.

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Lexington

Just not cricket

May 29th 2003
From The Economist print edition

A downright unAmerican national pastime

IMAGINE a business organised as follows. The number of firms is fixed. New entrants are banned. The head of the business can threaten to close down a couple of enterprises to restrict supplies. This is possible because the activity is exempt from anti-trust law (the largest markets, such as New York and Los Angeles, have just two suppliers; most have local monopolies). Certain classes of employees are indentured servants. Rich firms pay a marginal tax of 34% of revenues to poor ones. And the government helps build the lavish corporate headquarters.

Sounds crazy? Illegal? Downright unAmerican? Welcome to the world of major-league baseball. This is how the home of free-market capitalism has long organised its summer sport.

Now baseball is in trouble. Attendance is down again this year. In 2002, the Massachusetts attorney-general and a co-owner of the New York Mets both separately accused the baseball commissioner of conspiring to rig the sale of teams. The sport has a well-earned reputation for bad management. Its fan base is geriatric. “America's national pastime” may reign supreme among older fans, but teenagers often think baseball is slow and boring, compared with basketball and extreme sports. Participation in children's Little League is falling.

The masters of this struggling cartel—a legal entity called Major League Baseball—know what to do. The problem, they claim, has nothing to do with the sport's organisation. Because their product—a baseball game—is the result of teams co-operating to play, restrictions on business competition are fully justified. The real problem, they say, is that rich clubs have too much money.

Last season, the payroll of the gold-plated New York Yankees was three times that of the Montreal Expos, the church mice of the major league. In 2000, a “blue-ribbon panel” of sober baseball fans worried about “competitive imbalance”. Between 1995 and 1999, every World Series game was won by a team in the richest 25% of clubs (as measured by total player salaries). Baseball is doomed, the panel concluded, unless it makes special efforts to ensure that each team has a “regularly recurring reasonable hope of reaching [the post-season play-offs]”. To that end, Major League Baseball now wants the rich to give more money to the poor. At a time when politicians in Washington, DC, are reducing taxes, the baseball franchise has come up with a tax system of baffling complexity requiring the richer clubs to transfer around $260m this year to poorer clubs.

In fact, baseball seems no more susceptible to permanent domination than other sports. By applying business techniques to the sport—actuarially measuring tactics, hiring underpriced older players and so on—the Oakland Athletics turned themselves from cannon-fodder into American League divisional finalists in 2001 and 2002. Last year, lowly Anaheim disposed of the Yankees in the World Series play-offs; Montreal and Minnesota have both made good starts this year. Like all the best sports, the secret of success in baseball is a recurring mystery: no sooner does one team figure out how to win all the time, than another comes along to do better.

Next, it is not clear that revenue-sharing is the right way to help improve poor clubs. As Andrew Zimbalist, an economist at Smith University, shows in a recent book (“May the Best Team Win”, Brookings Press), if a poor club earns more money by cutting payroll and getting a bigger subsidy next year than by buying good players and attracting fans this year, then its rational response is to pocket shared revenue, not invest it. Revenue-sharing actually encourages some weak clubs to get worse.

Meanwhile, over the past few years, successful clubs—ie, those whose money baseball wants to give away—have stopped being stand-alone teams and turned themselves into the heart of cable-television networks. Five of the eight richest clubs either own, or are owned by, media firms. By using dubious transfer prices, baseball-owners can switch profits from the teams to cable companies. As Mr Zimbalist shows, the accounts of most baseball teams are fiction, which makes revenue-sharing impossible to administer. And it sabotages Major League Baseball's claim that, because most teams lose money, the sport cannot be a monopoly because it does not earn monopoly profits.

A ballpark figure

The truth is simpler. Baseball is a subsidised industry, hooked on anti-competitive behaviour. With the number of clubs fixed, club owners blackmail their host cities by threatening to leave unless they get shiny new ballparks at taxpayers' expense. Since 1989, 16 new baseball stadiums have been put up, costing $5 billion. Two-thirds of that came from public coffers.

And like other subsidised industries, baseball is fertile ground for elaborate schemes to offset one distortion by introducing others. Revenue-sharing is one example. Another is the (shelved) proposal to reduce the number of teams to benefit the rest. Last year, Major League Baseball introduced “safety” rules that threaten to put some baseball-bat makers out of business, turning another industry into a branch of the baseball cartel, and transforming the sport's competitive flaws into a virus.

A better way is to tackle the problem at source. Major League Baseball has been exempt from antitrust law since 1922. This is unfair: it means players who join from the minor leagues have no choice about who employs them for six years; it hides the sport from public scrutiny (hence the opaque accounts); it makes the stadium subsidy possible.

Getting rid of that exemption would not turn baseball into a free for all—nor should it. Baseball is such an attractive game partly because its rules strike a balance between all-out competition and fair play. The real case for reforming the sport is to reinstate that very American balance, rescuing the sport from a system, which, as it stands, is neither competitive nor fair.

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Argentina's new president

The empty-handed social democrat

May 29th 2003 | BUENOS AIRES
From The Economist print edition

Reuters

Néstor Kirchner has made a decisive start. But his ambition to move leftwards will be tempered by Argentina's penury

Get article background

PERONISTS come in all shapes, sizes and ideological colours. Néstor Kirchner, who took office as Argentina's president on May 25th, has been quick to portray himself as a social democrat and political reformer. In a defiant inauguration speech, billowing with windy rhetorical criticisms of the free-market reforms of the 1990s, he made some ambitious and expensive promises. But Mr Kirchner has taken charge of a bankrupt country and has a weak mandate. Change is likely to be gradual and cautious. But it will be change.

The president's first moves have been aimed at stamping his authority on his office. A previously little-known provincial governor, he won 22% of the vote in last month's presidential election, and was robbed of a certain triumph when his opponent, Carlos Menem, pulled out of a run-off ballot. So it was no surprise that Mr Kirchner claimed that his inauguration was a fresh start for a country whose politicians are discredited by economic failure. He promised new policies in several areas, including the economy, political institutions and foreign relations.

On the economy, Mr Kirchner called for a central role for the state and a public-works programme to spur growth and jobs. The government could not restart debt payments “at the price of the hunger and exclusion of Argentines”, he said. He will seek a reduction in the debt, a cut in interest rates and more time to pay. The president has also refused an IMF request to veto a bill suspending the bankruptcy law for a further three months, preventing banks from seizing debtors' assets. His office slapped down the (supposedly independent) central bank governor, who had warned against any attempt to fix the peso.

In much of this, Mr Kirchner is simply staking out a tough negotiating position ahead of talks with creditors and with the IMF. Debt default was not his project, he stressed. He has kept the economy minister, Roberto Lavagna, who has won the respect of investors. Mr Lavagna said that the government will not seek to suspend the bankruptcy law again. The public-works scheme will be limited by lack of funds. But some economists worry about how interventionist Mr Kirchner plans to be.

The new president's most dramatic move was to sack 52 senior military officers—the biggest purge since democracy was restored in Argentina in 1983. The outgoing army commander faced accusations of human-rights abuse during the 1976-83 dictatorship. The purge also allowed Mr Kirchner to appoint commanders who have his trust, having served in his Patagonian province. But it will also save money, and was a fairly easy way of showing the country who is in charge.

His next target is the Supreme Court, and particularly its “automatic majority” of judges loyal to Mr Menem, Argentina's president from 1989-99. The new government seems to have gathered enough support in Congress to impeach one of them, Carlos Fayt, who is accused of conflicts of interest. That may encourage others to resign. Since the judges are deeply discredited, their removal would be popular.

Mr Kirchner claimed that he would not buy political support by slackening off on the fight against corruption. A first test of that promise will be whether he allows the nominally independent National Judicial Council to pick new judges, rather than following Argentine political tradition by himself picking cronies.

In foreign relations, as with the economy, Mr Kirchner is unlikely to stray far from the policies of Eduardo Duhalde, the outgoing president. These have involved a break with Mr Menem's pursuit of “carnal relations” with the United States—a stance derided by Rafael Bielsa, the new foreign minister. Watched by Fidel Castro, who came to Buenos Aires for the inauguration, Mr Kirchner promised to restore full diplomatic relations with Cuba. But his priority will be close relations with President Lula da Silva's Brazil, the first country he plans to visit. Like Lula, Mr Kirchner wants to revive the Mercosur trade pact. But Mr Kirchner also plans to visit the United States, with which he wants a “serious, extensive and mature relationship.”

At best, Mr Kirchner's Argentina might look something like Lula's Brazil: a centre-left and moderately nationalist government that sticks to responsible economics while attempting social reform. But Lula has a disciplined party behind him, and Brazil's institutions are more robust than Argentina's. Mr Kirchner has little political backing; his authority may depend greatly on his popularity. The flipside of Peronism's flexibility is a long record of populist mediocrity. Mr Kirchner has an opportunity—but much to prove.

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Campaign finance in Mexico

Peculiar practices

May 29th 2003 | MEXICO CITY
From The Economist print edition

The high cost of democracy

Get article background

ON JULY 6th Mexico will hold a mid-term election in which the 500-seat lower house of Congress and several governorships are at stake. Much though President Vicente Fox and his conservative National Action Party (PAN) would love to win the legislative majority they need for their liberalising reforms, that looks unlikely. Few pundits expect much change in Congress, where the formerly ruling Institutional Revolutionary Party (PRI) remains the largest party. Neither of the main parties has chosen to turn the election into an ideological battle. Instead, it is being clouded by rows and scandals over campaign finance dating back to the presidential election of 2000.

The PRI was recently convicted of receiving more than $45m in illegal funding from the trade union at Pemex, the state oil company. The independent Federal Electoral Institute has imposed on the PRI a record fine of 1 billion pesos ($98m). That has resulted in the bathetic spectacle of the once-omnipotent PRI asking its supporters for a peso a day to help it pay the fine. But its campaigning will not be greatly affected: it has two years from the end of July to pay up. PRI officials say that the scandal has hurt the party's standing with the chattering classes, but not with the average voter. Polls seem to confirm this. Perhaps, say cynics, that is because the party had no reputation to lose.

The PAN has a scandal of its own. This involves allegations that the “Amigos de Fox”, a campaign support committee, tapped American companies and wealthy foreigners during the 2000 race. Foreign campaign donations are illegal in Mexico. No clear proof has emerged. But Mr Fox has more to lose than the PRI, having been elected on a promise to cleanse Mexican public life. That is why PRI politicians are refusing to let the matter drop.

Many Mexicans say the real scandal is not the money the parties may have raised on the side, but the huge amounts they are given up front from public funds. Political parties are allowed to raise only 10% of their money privately. The rest comes from taxpayers, an arrangement partly designed to keep drug money out of politics.

This year, the 11 parties fielding candidates will receive a total of around $500m, and the electoral institute roughly the same amount to organise the vote. Critics point out that the money keeps alive a number of small parties that have no other apparent life. And 60% of the campaign money goes to the television channels, which charge a fourfold premium for campaign spots in prime time.

The electoral institute, one of Mexico's most respected institutions, has itself fallen under a small cloud. It emerged last month that ChoicePoint, an American firm, had bought personal data on millions of Mexicans, some of it taken from the electoral register. An investigation has been launched into how it got the supposedly confidential data. To some voters, it looks like just another wagon in the endless gravy-train of Mexican politics.

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Brazil's president and his Congress

A majority, sort of

May 29th 2003 | SÃO PAULO
From The Economist print edition

Capricious allies and friendly foes

Get article background

IF YOU are a president plotting reforms that offend many, a legislative majority helps. Brazil's president, Luiz Inácio Lula da Silva, has not had that luxury since taking office in January. Now, at least on paper, he does. On May 27th, after months of haggling, the Democratic Movement party (PMDB), the third largest in Congress's lower house (and largest in the Senate), joined the governing coalition. This gives Lula the three-fifths majorities in both houses needed to pass constitutional changes—including vital reforms of tax and social security. But majorities in Brazil's Congress are fickle, and Lula may yet have to rely on votes from the opposition.

Few parties are more opportunistic than the PMDB. Its origin was as the opposition party authorised by Brazil's military dictators of 1964-85. It has been part of almost every democratic government since then. Its reward for joining Lula is expected to include at least one ministry in a reshuffle in December and, in the meantime, more than a dozen lesser posts.

The trouble is that the PMDB is less a coherent party than a confederation of regional barons bound together by a popular political brand name. Some are deeply hostile to Lula and his Workers' Party (PT). “The PMDB will never give 100% of its votes,” says Sérgio Abranches, a political scientist in Rio de Janeiro. Others in the ungainly governing coalition, which includes small populist and leftist parties, are also likely to be awkward.

But the gravest threat to the government may come from dissidents within Lula's own Workers' Party. They think that the reforms betray the party's left-wing principles. Luciana Genro, one of the rebels, says she “would feel raped” if she had to vote for pension reform without a party-wide plebiscite beforehand. Dissidents are a minority, and only a few of them would dare vote against the government. But left unpunished, any opposition from the PT's own ranks would invite more.

Party bosses seem unsure what to do. They had been moving towards expelling four of the most vociferous dissidents, including Ms Genro. But a step towards that, a hearing of the party's ethics commission scheduled for this week, was postponed. One possible compromise is that the dissidents would not show up when Congress votes on the reforms.

In all, guesses Mr Abranches, a fifth of Lula's newly minted majority may fail to back some clauses of the reforms. That would not necessarily be a disaster: the government can drum up the missing votes from opposition parties, which are friendlier to the reforms than many of its allies. In Brazil, it takes more than a paper majority to deliver votes in Congress.

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Drug policy in Canada

Just say yes

May 29th 2003
From The Economist print edition

Free marijuana, annoy Americans

JEAN CHRÉTIEN, Canada's soon-to-retire prime minister, delights in reminding Americans that his country is a different place. Now he has done so again. On May 27th his government unveiled a bill that would partially decriminalise marijuana. Instead of the current stiff penalties, possession of up to 15 grams (half an ounce) of the drug—enough, perhaps, for 50 joints—would be punishable with a fine, levied by ticket, of C$150 ($111) for an adult.

The bill's aim is to concentrate resources against heavy drug use. But it is bound to cause friction with the United States. Already, Canada's efficient marijuana producers export southwards perhaps $2.5 billion a year. American officials worry that this trade will now increase; they have threatened to tighten border controls in response.

In fact, the bill contains harsh penalties, of up to 14 years in jail, for marijuana growers. It sets out a pragmatic, European-style drug strategy, funded with C$245m over five years. The focus is on harm reduction, and educational campaigns about the dangers of drugs.

Canadians are divided about the new policy's merits. The police and the opposition Alliance are critical. Even so, the bill may pass before Mr Chrétien steps down early next year. In 2001, Canada legalised the medical use of cannabis. Soon, Canadians may be able to roll up for pleasure.

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Islam in South-East Asia

Incense, silk and jihad

May 29th 2003 | PARANGTRITIS, INDONESIA
From The Economist print edition

Corbis

Muslims in South-East Asia have long been renowned for their tolerance. It may yet keep extremism at bay

Get article background

“IN THE name of God, the compassionate, the merciful,” the turbaned priest begins in the orthodox Muslim style. But that is as far as orthodoxy goes. As the annual *labuhan* ceremony unfolds, he blesses the various offerings the Sultan of Yogyakarta has prepared for Loro Kidul, the goddess of the surrounding seas: silk, curry, bananas, hair and toenail clippings.

The goddess, apparently, will be pleased with these items when they are carried in procession to the sea and thrown in, as will another local deity, who receives similar gifts tossed into a nearby volcano. The 200-odd participants, at any rate, seem happy with the proceedings: they bow their heads during the blessings, and take turns lighting incense at a curiously-shaped rock that is the focus of the cult. Later, some even charge into the foaming ocean to pluck a lucky banana from the waves.

This ritual has more to do with Java's Hindu and pagan past than with the professed religion of the vast majority of the island's inhabitants, Islam. Votive offerings, veneration of objects or idols and, above all, any hint of polytheism are anathema to most Muslims. Yet many Javanese happily describe themselves as Muslim, attend mosques and fast during Ramadan, while continuing to practice the folk religion of their forebears. The sultan himself, Hamengkubuwono X, a respected politician often mentioned as a possible president, takes pride in the preservation of local rituals while maintaining a reputation as a devout Muslim. This laxity about doctrine has given rise to the notion that Indonesian Islam in particular, and South-East Asian Islam in general, is more tolerant and less prone to extremism than that of the Middle East.

Yet last October's atrocity in Bali, in which Muslim extremists killed some 200 customers and employees at two adjacent night-clubs, calls into question this supposed moderation. And Bali was just the most bloody of many recent attacks apparently committed or planned by South-East Asian Muslims in the name of the faith, including bombings of embassies, offices, buses, malls and churches in Indonesia, Malaysia, Singapore and the Philippines.

Just an hour's drive from Yogyakarta stands the religious school run by Abu Bakar Basyir, the alleged leader of Jemaah Islamiah, a shadowy group said to be the brains behind many of these attacks. Mr Basyir, whose trial for treason opened in Jakarta on April 23rd, certainly espouses an intolerant and

bloodthirsty brand of Islam, more akin to Osama bin Laden's than to that of the devotees of Loro Kidul. Mr Basyir, in turn, is only the most radical of a number of clerics who are striving to strip South-East Asian Islam of its pagan trappings and draw it into line with orthodox practice elsewhere. Even the mainstream Muhammadiyah movement, Indonesia's second-largest Islamic organisation, wants to put an end to rituals like the *labuhan*.

So which is the true face of South-East Asian Islam? The short answer, of course, is that there is none. Muslims in the region are as varied in their behaviour and ideas as Christians in America or Hindus in India. But insofar as it is possible to generalise, the popular practice of Islam is becoming stricter and less syncretic. The change stems in part from increasing urbanisation, education and contact with the outside world, which has prompted a decline of rural folk religion. Foreign funding and preaching also play a part. But hamfisted political intervention in matters of the faith has hastened the trend and fuelled extremism. Given an open debate about the role of religion in society, South-East Asian Muslims would have little cause to abandon their moderate traditions. But, until recently, an open debate of that kind is something that most South-East Asian governments have strenuously avoided.

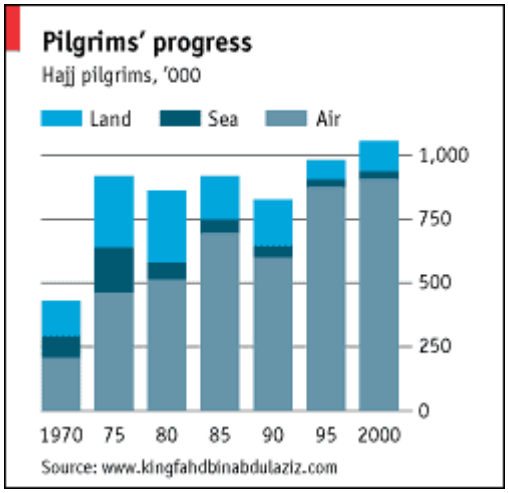
Piety's progress

It is not clear when Islam came to South-East Asia, and whether Arabs, Persians or Indians were its main disseminators. But there is no doubt that it was spread for the most part by merchants, rather than the warriors who brought it to the Middle East and North Africa. Local people seem to have converted gradually, while preserving many of their pre-Islamic beliefs. For a long time, Muslims remained a minority, and had to learn to rub along with people of other faiths. Hindu kingdoms endured in Java until the 16th century, for example, while Spanish colonisers and Muslim preachers seem to have arrived in the Philippines only a few decades apart.

What is more, the merchant missionaries themselves seem to have followed a fairly unorthodox brand of Islam. They introduced Sufism, a form of mysticism frowned upon by dogmatic Muslims. And although almost all South-East Asian Muslims follow the Sunni sect, Shia holidays have entered the local tradition. To this day, even the Acehnese, popularly considered the region's most devout Muslims, celebrate Ashura, an exclusively Shia festival in the rest of the Islamic world.

But efforts to purify South-East Asian Islam also have a long pedigree. The Muhammadiyah organisation was founded, in 1912, in order to spread a more conventional interpretation of the faith. Since then, the divide between *santri*, or orthodox Muslims, and *abangan*, the followers of folk religion, has dominated Muslim politics in Indonesia—which alone contains almost 90% of South-East Asia's Muslims. The Nahdlatul Ulama (NU), the biggest group sympathetic to the *abangan*, still claims more members than Muhammadiyah (40m, compared with 30m). But the numbers of the *santri* have swelled as Indonesians move to the cities and lose contact with their rural traditions.

The Iranian revolution in 1979, and the worldwide Muslim revival that accompanied it, accelerated the trend. Attendance at mosques rose; many Muslim women began wearing headscarves, a relative rarity until then; and the numbers of pilgrims to Mecca soared (see chart). When the Soviet Union invaded Afghanistan, several thousand South-East Asian Muslims went to fight for the *mujahideen*.



Nowadays, public displays of piety have become something of a fad. Titiek Puspa, one of Indonesia's most famous pop stars, recently went on pilgrimage to Mecca. Television executives say there is ever increasing demand for Islamic programming. Abdullah Gymnastiar, a wildly popular Muslim televangelist-cum-management-guru, is setting up a service called al-Quran Seluler, which allows devotees to receive his analysis of Koranic verses by text message or voicemail. According to Bahtiar Effendy, an Indonesian academic, this trend is all the more remarkable for being spearheaded by the urban elite, who as recently as the 1960s tended to dismiss religion as outmoded and primitive. “Today, the only way to be socially accepted is through Islam,” he says.

Schools and university campuses are at the centre of the revival. Rico Marbun, a student leader at the University of Indonesia, explains how some of his peers in high school persuaded him to convert from

Protestantism to Islam. He then joined a Muslim missionary club that visited other schools and universities to spread the faith. He says there are hundreds of such clubs at all universities around the country, which blend the propagation of *santri* Islam with everything from singing to mountain-climbing. Other students tell the same tale: how they had been raised as *abangan* by their parents, but adopted a more stringent version of Islam under the influence of their classmates. As the number of university students has grown over the decades throughout the region, so has the number of South-East Asians exposed to this form of Islam.

Fashion or conviction?

There is nothing inherently alarming in a religious revival, of course. America went through one in the 1980s without any catastrophic fallout. In fact, many observers dismiss South-East Asia's new-found piety precisely because it seems to have more to do with fashion than conviction. As one well-to-do resident of Jakarta says of her cousin's decision to start wearing a headscarf, “I think she just did it because it's trendy. All her friends are doing it.”

Besides, revivalism—even if sincere and deep-rooted—need not lead to extremism, nor extremism to violence. A clear majority of Indonesian Muslims still vote for secular parties, just as their Malaysian brethren still prefer the mild Muslim nationalism of the ruling United Malays National Organisation (UMNO) to the more doctrinaire Pan-Malaysia Islamic Party (PAS). When a motion seeking to enshrine Islamic law in the constitution came before Indonesia's parliament last year, even most of the religious parties voted against it. Around the same time, the minister of religion, Aqil al-Munawar, publicly revealed that he consulted soothsayers—an *abangan* practice. Over Christmas and New Year, Islamic groups organised patrols to defend churchgoers and revellers against extremist attacks.

Salahuddin Wahid, a senior member of NU, tends to play down the region's religious revival as a natural reaction to breakneck social and economic change. In times of flux, he argues, people crave the reassurance of religion. Since South-East Asia was the world's fastest-growing region throughout much of the 1980s and 1990s, it was particularly susceptible to an Islamic renaissance. By the same logic, the Asian crash of 1997 caused further tumult and an even more widespread resort to the comforting certainties of Islam. Should Indonesia ever regain stability, Mr Wahid predicts, the religious fad will fade.

Other analysts attribute the region's religious revival—or at least the most extreme form of it—to the increasing influence of foreign Muslims. For decades, rich Gulf Arabs have paid for South-East Asian students to study Islam in its Arab heartland. They have also funded the construction of mosques and the operations of Islamic schools and charities. Some of these are clearly involved in the dissemination of radical ideas. Filipino police say Muhammad Khalifa, a relative of Mr bin Laden, used an Islamic charity as cover for his funding of Muslim separatists and terrorists when he lived in the country in the early 1990s. In a report issued early in January, Singapore blamed the spread of radicalism among its Muslims on militant Arab foundations that run schools and mosques in the city-state.

Not even Cambodia's obscure Muslim community has escaped the zealots' attention. The Cambodian Islamic Development Council, a Muslim NGO, estimates that at least 10% of local Muslims now follow the puritanical Wahhabi sect, thanks to aggressive Saudi Arabian proselytising. On May 28th, Cambodian authorities charged an Egyptian and two Thais with plotting terrorist attacks in Phnom Penh for Jemaah Islamiah.

Almost all of Indonesia's best-known Muslim militants studied overseas at some point, including Mr Basyir, and many of them fought in Afghanistan. Most of the latter, it turns out, were persuaded to join the *jihad* only after they had arrived at Islamic boarding schools in Pakistan or the Middle East. When they returned to South-East Asia, they set up schools of their own with similar agendas. Several of the suspects in the Bali bombing attended such a school run by Mr Basyir in Malaysia, where they acquired their radical ideas—and, perhaps, their terrorist directives.

Needed: free debate

But authorities in the region cannot prevent their citizens coming into contact with radical ideas from abroad. The only sure way to counter such ideas is to foster an open debate about Islam, in the hope that most people will eschew its more militant forms. Until recently, however, the two biggest Muslim countries in South-East Asia have done just the opposite. In both Indonesia and Malaysia, authoritarian rulers tried to outflank Islamist opposition by adopting a policy of “Islamisation” even as they cracked

down on its most radical proponents. The result was a double failure: they ended up advancing the religious revival that had nurtured the opposition in the first place, while also stirring resentment at their heavy-handed tactics.

Take Malaysia. Mahathir Mohamad, its prime minister for 20 years, attempted to defuse criticism from Islamists by building mosques, promoting religious education, increasing the role of religious courts and supporting Islamic financial institutions. He also drafted popular Muslim leaders such as Anwar Ibrahim, his one-time deputy, into UMNO, the ruling party. But the adoption of each successive “Islamic” measure simply encouraged UMNO's rival, PAS, to demand another.

At the same time, Dr Mahathir tried to paint PAS as extremist by accusing its members of plotting against the state. Even before the attacks of September 11th 2001, he had denounced dozens of members of PAS as terrorists and locked them up without trial, in what many Malaysians believe was a political smear campaign. Thus PAS earned support from those who might normally shy away from its political agenda.

Indonesia's record is even worse. In the 1990s Suharto, the country's long-standing dictator, began promoting public religiosity, while continuing his long-standing practice of fiercely repressing any Islamist political opposition (see article). Since Mr Suharto's fall in 1998, and the introduction of multi-party democracy, former dissidents like Mr Basyir now enjoy a certain radical chic. Indeed, the memory of political repression in Indonesia is so strong that few public figures dare declare any views that go beyond the pale.

That reticence has allowed extremists to dominate the news and intimidate more moderate Muslims. A newspaper editor describes how a mob of militants threatened to destroy his offices unless he retracted an article critical of radical Islam.The police were no help, he says, so he did as the protesters demanded. Under similar pressure, television stations have withdrawn supposedly “unIslamic” programmes and even, on one occasion, agreed to change the name of a character in a soap opera deemed insulting to Islam.

Nor are humbler folk immune from such intimidation. University students often complain that Islamic zealots patrol campuses to harass anyone caught canoodling in public. Other radicals have burned down mosques used by members of the Ahmadiya sect, whom they consider heretics. The Islam Defenders Front (FPI), a vigilante group, trashes sinful bars and brothels. Another militant organisation, Laskar Jihad, has recruited and trained a militia to fight sectarian battles with Christians in Indonesia's outlying provinces. Some reports even suggest that rogue elements in the security services helped to set up these groups. At any rate, they did nothing to stop them. Nor did anyone rein in a certain Muhklas, who this week admitted his involvement in the Bali bombing, when he attempted to burn down an *abangan* shrine in his home village in Java.

During her first year in office, Megawati Sukarnoputri, Indonesia's president, seemed maddeningly oblivious to all this. Although her mother was a Balinese Hindu and she herself shows *abangan* instincts, Miss Megawati refused to curtail or even condemn the extremists. But just before the Bali bombings, ironically enough, she finally succumbed to foreign remonstrations and launched a crackdown. The authorities arrested and tried several members of FPI, as well as Jaafar Umar Thalib, the leader of Laskar Jihad (who was later acquitted). After the bombing, the police arrested Mr Basyir, a step they had rejected until then. Laskar Jihad, sensing which way the wind was blowing, either disbanded or went underground.

EPA

They arrested Basyir

Tolerance reasserted

A recent row about the treatment of a controversial religious scholar illustrates the improving climate. Ulil Abshar Abdalla, the founder of a group called the Islamic Liberals Network, wrote an article last year rejecting elements of Islamic law and decrying those who insist on a literal interpretation of the Koran. The newspapers then reported that a group of such literalists, called the Forum of Clerics of the Faithful of Indonesia (FUUI, by its Indonesian acronym), had issued a sentence of death against Mr Abdalla for blasphemy. Several respected clerics leapt to his defence, and FUUI, under pressure, denied that any such sentence had been issued.

Dr Mahathir also seems to be changing tack. Last year he stopped state funding for private Islamic schools, has shut down many of them, including Mr Basyir's former one, and is encouraging their students to move to state schools, putting religious education in the hands of the state.

This climate has helped to promote a vigorous debate about the proper role of Islam in both countries. Indonesian newspapers accord theological arguments between clerics the sort of coverage reserved for feuding pop stars in the West. Sisters in Islam, a Muslim women's organisation, is leading a campaign against two Malaysian state governments' plans to adopt full-blown Islamic law. The liberal Mr Abdalla pops up all the time on Indonesian television and radio shows. As long as the moderates keep on getting their fair share of air time, there is every hope that the extremists will fail.

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China

Mr Hu's grand tour

May 29th 2003 | BEIJING
From The Economist print edition

The new president gives priority to Russia

Get article background

MAKING his first foreign foray since he became China's president, Hu Jintao chose his destinations with some political subtlety. His itinerary seemed to imply that the United States was not necessarily the first place a new national leader should seek to visit. Russia was the first and longest leg of his ten-day tour, a visit designed to keep strong the ties that that were formalised in 2001, when the Russian president, Vladimir Putin, signed a treaty of friendship with Mr Hu's predecessor, Jiang Zemin.

Then Mr Hu was off to Central Asia, where China is becoming the dominant force in the six-member Shanghai Co-operation Organisation, a group that at present focuses mostly on counter-terrorism but aims to expand into economic co-operation as well. Lastly, Mr Hu was travelling to France for this weekend's Group of Eight (G8) summit of industrialised nations, which has graced him with an invitation to attend as an “observer”.

AFP

The down-to-earth duo

During Mr Hu's time in Russia, the two sides concluded a lucrative oil-pipeline deal, and exchanged their like-minded views on the importance of maintaining an international strategic balance, their concern no doubt promoted by America's military and economic might. But the two countries' trade relationship continues to be disappointing, and this, according to one Chinese academic, is bound to weaken the political relationship if it continues. Since the early 1990s, the two sides have aimed for a target of $20 billion in bilateral trade, but now Mr Putin predicts it will not be met for at least another four or five years.

Chinese goals in France will be more easily met. Still tied to its identity as a leader among developing countries, China demurs that it could not possibly consider joining the G8, not yet, anyway. This is all to the good, since China has not yet been invited. But for Mr Hu, it will be a boost in prestige both at home and abroad simply to be seen at the table of this exclusive club.

Despite China's carefully cultivated focus on other relationships, it is inevitable that Mr Hu's meeting on the G8 sidelines with George Bush will be the most important and closely watched encounter of his trip. This, in no small part, is due to a decision by the United States on May 22nd to slap sanctions on Norinco, a huge Chinese military-industrial conglomerate, for, it is claimed, transferring missile

technology to Iran, in violation of non-proliferation agreements.

Norinco has been punished by the Americans before, during the Clinton administration, but only on a very narrow range of products. Mr Bush's sanctions go much further, banning American imports from any of Norinco's many subsidiaries for the next two years. Such products include not only the military hardware for which Norinco is famous, but also carpets, shoes, toys, building materials, motorcycles and more. The Norinco exports now jeopardised are reckoned to be worth at least $100m annually.

Yet even unfriendliness on this scale may not be enough to sour the tone of Mr Hu's meeting with Mr Bush. The United States claims to have firm proof of Chinese violations and China has denied the charges and lodged a protest. Otherwise, neither side has said much more about the matter. According to Robert Ross, a China specialist at Boston College, both sides would be better off leaving the dispute to lower-ranking specialists to sort out quietly. America still hopes to get more Chinese help in dealing with the North Korean nuclear issue. China, meanwhile, is looking to buff up its image after receiving criticism of its handling of the deadly disease SARS. “Hu Jintao doesn't want headlines, and he certainly doesn't want to see heightened tensions with America at this point,” says Mr Ross.

In addition to sending signals about how China sees its place in the world, Mr Hu is using his trip to firm up his own place in the Chinese political universe. Nominally the top figure in both the state and the Communist Party hierarchies, Mr Hu must still contend with the hulking legacy of his predecessor. Mr Jiang has not gone away. In what many Chinese clearly see as a peevish dig at him, Mr Hu has scrapped the grandiose tradition of showy departure and return ceremonies for top leaders on foreign trips.

Such simplicity from a leader strikes many in China as a refreshing change from the pomposity of Mr Jiang who, it was clear to see, enjoyed all the ceremony. Nor can the more subdued Mr Hu be expected to indulge in the sort of showmanship favoured by his predecessor, whose singing and poetry recitals looked to many Chinese, and perhaps to his hosts as well, suspiciously like so much buffoonery.

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Japan's security

Onwards and upwards

May 29th 2003 | TOKYO
From The Economist print edition

Japan continues to clarify the rules governing its troops

Get article background

SHOULD he pause to enjoy the view, or try to march Japan's defence policy up the next hill? That was the question facing Junichiro Koizumi this week, as he and his cabinet pondered sending the self-defence forces (SDF) to help rebuild Iraq. Getting approval for the mission would be a tough climb in the legislature, and Mr Koizumi is keen to wrap up the current Diet session as scheduled on June 18th. But the prime minister has built up momentum with a string of successes on security issues. As of May 29th he was still thinking it over.

Mr Koizumi's most recent victory was the lower house's passage of a set of security bills in mid-May. The bills, which the upper house is expected to approve in early June, will streamline the rules for responding to attacks and other emergencies. Although Japan's war-renouncing constitution allows self-defence, the mere thought of using force is so unsettling to many Japanese that successive governments have found even small procedural changes hard to get passed. The bills just approved deal with unaddressed emergency contingencies—such as a need to use private land, evacuate areas, or bypass local red tape—that the Fukuda government first highlighted in the 1970s. Yet even last year, a quarter-century later, the public was still not ready, and Mr Koizumi then failed to get the bills through.

This time, however, Mr Koizumi not only succeeded, but did so with support from the biggest opposition party, the Democratic Party of Japan, along with one of its coalition partners, Ichiro Ozawa's Liberal Party. Another bill delineating civilians' rights in an emergency will have to be enacted within 12 months for the package to take effect.

Seiji Maehara, a Democrat who helped craft this compromise, hinted in a talk to foreign journalists this week that a change of his party's leadership—Yukio Hatoyama resigned late last year and was replaced by Naoto Kan—resulted in a greater willingness to co-operate. The public's heightened fears of North Korea, and their apparent support for Mr Koizumi's handling of foreign policy, no doubt helped as well. Whatever the reasons, and however innocuous the legislation's details, it is a big step for Japan. Taku Yamasaki, the secretary-general of Mr Koizumi's Liberal Democratic Party, praised the lower house's “supra-partisan” support and hailed the bill as “epoch making”.

The next challenge facing Japan's security planners and foreign-policy makers will be to clarify some of the links between Japan's defence of its homeland and the activities that the SDF undertakes outside Japanese territory, especially in co-operation with its American allies.

A law in 1992, following Japan's relative inaction in the first Gulf war, set out rules for taking part in distant UN peacekeeping operations. Then Japan began thinking more clearly about its co-ordination with American forces in Japan's immediate neighbourhood. That legislation passed in 1999, a year after North Korea launched a missile over Japan. Now, at last, Japan has cleared up some of the rules for handling an actual attack. More important, Mr Koizumi's recent victories suggest that Japanese are growing more comfortable about debating their security.

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Pakistan

Out with vice, in with virtue

May 29th 2003 | LAHORE
From The Economist print edition

Pakistan's Islamists are getting bolder

THE University of the Punjab in Lahore, once the premier seat of modern learning in the sub-continent, is busy bowdlerising English literature these days. The term derives from Dr Thomas Bowdler (1754-1825), a British editor, whose Family Shakespeare was cleansed of “those expressions which can not with propriety be read aloud in the family.” Among the celebrated works long taught in Pakistan's BA and MA classes and now targeted for the treatment are Swift's “Gulliver's Travels”, Pope's “The Rape of the Lock”, Fielding's “Joseph Andrews”, Donne's poetry, and Hemingway's “The Sun Also Rises”.

EPA

Fiery Fazlur

Apparently, the orders for a clean-up operation came from no less a figure than the president, General Pervez Musharraf. According to Dr Shahbaz Arif, who has been entrusted by the university's vice-chancellor and registrar (both retired army officers) with the job of cleaning up the English curriculum, and relishes it, “there are so many vulgar words, concepts and thoughts in the current English curriculum that they can induce our youngsters to erroneous thoughts and ways.” The word rape in “The Rape of the Lock” evokes a negative image, claims Dr Arif. Words like vodka, whisky and wine are strictly taboo in an Islamic society and will have to be removed.

The attack on literature comes on the heels of an attempt by zealots of the fundamentalist Jamaat-e-Islami to demote English as a compulsory subject in higher education. The Jamaat wants Arabic, the language of the Koran, to replace English as the second language, after Urdu, in the country.

But it is in the North-West Frontier Province (NWFP) bordering Afghanistan where Islamisation (some call it Talibanisation) is now making the most dangerous inroads. In the last two weeks, Jamaat vigilante squads in Peshawar have wrecked hoardings advertising foreign consumer goods like Coke, Pepsi and Pizza Hut because unveiled women figured in them. And, on Tuesday May 27th, the provincial government of the Muttahida Majlis-i-Amal, an alliance of six religious parties led nationally by the fiery Fazlur Rehman, floated a *sharia* bill in parliament to amend at least 71 existing laws in order to make them conform to Islamic tenets.

The bill also proposes the establishment of a “vice and virtue committee”, with powers to use the police, bureaucracy and lower courts to enforce its definition of what is good and what is bad in society. Critics fear this could involve forcing people to say their prayers five times a day, ensuring that everyone fasts during Ramadan, insisting that all women should be veiled, banning co-education even in primary schools, closing down video, film and music shops, and so on. Apparently, its decisions are to remain outside the purview of the High Court of the province. The federal government in Islamabad also has little say over the move. The bill is expected to pass, as the Islamists have a solid majority in the

provincial parliament.

But there was one memorable moment in the NWFP's parliament when the *sharia* bill came up for discussion. A couple of ruling-party women members stood up to dilate on the subject. The speaker was nonplussed. The reason: they were dutifully attired from head to toe in the regulation *burka*, or veil—and so could not be identified, as required by the parliament's rules of procedure.

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India

Never thirsty again

May 29th 2003 | CHENNAI
From The Economist print edition

A scheme to harvest India's abundant rainwater

THE city of Chennai in southern India, the country's fourth largest, gets a reasonable amount of rainfall during the months of the monsoon, sufficient in theory to provide enough water for its growing population. The trouble is that in the past 90% has been wasted. The city's reservoirs are filled, but most of the rest of the rainfall finds its way into the sea or runs off into drains. Sekhar Raghavan believes he has the answer. Last August, with other campaigners, he set up in Chennai the country's first Rain Centre, adapting to urban use an old idea called rainwater harvesting, or RWH, to stop the country going thirsty during the non-monsoon months.

At the Rain Centre, Mr Sekhar, a physics professor, demonstrates that rain falling on a typical Chennai flat roof can be gathered for use by the household in the kitchen and bathroom, and the rest channelled into wells where it can be used or go to replenish the water table. Most of the city is built over, so it is important that the rainwater is channelled past the built-over surfaces into the soil, where it tops up the water table. A harvesting system costs about $60 for a house or $600 for a block of flats. A slum dwelling can be simply kitted out for $4.

A number of politicians have publicised RWH by installing it in their homes. The Indian Oil Corporation reckons that its use of RWH is saving 60,000 litres (15,850 American gallons) of city water a day. The government has made RWH mandatory for all new buildings. The order is supposed to be extended to all tax-paying buildings by the end of this year, an optimistic target. Chennai has 70,000 RWH structures so far. Delhi is following suit. So, too, should other rainy cities throughout the world, says Mr Sekhar. On a typical Indian house plot, the technique can yield over 700 litres per day over a year, he says, enough for a five-member family.

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America, Syria, Iran and Hizbullah

Please sir, we really didn't

May 29th 2003 | CAIRO
From The Economist print edition

America has changed the rules of the game

ON THE old Middle East chessboard, the Iranian bishop and the Syrian knight were nimble allies. Often aided by their little Lebanese pawn, Hizbullah, they thwarted the ambitions of other players, including Iraq, Israel and America. But now the superpower has abruptly changed the game, and is imposing new rules. Stalemate is no longer an acceptable outcome. Whether the issue is stabilising Iraq, herding Israelis and Arabs towards peace, hunting down outlaws or staunching the spread of weapons, America signals that it intends to sweep the board.

It is hardly surprising that Syria, Iran and Hizbullah should be hostile to American designs. Both countries have creaky economies and weak armies. Their regimes are isolated, even at home. Iran's revolutionary religious zeal was long ago replaced, in the minds of most of its people, by sullen resentment of rule-by-*fatwa*. Syria's Baath party is an empty, sloganeering shell. Hizbullah remains popular, but only among its core constituency. Without the increasingly shrill-sounding call to “resistance” it would be just another of Lebanon's bickering factions.

In the eyes of such players, greater American influence simply translates into a loss of their own. Syria's regime, split between timid reformers and a grasping old guard, frets that it may have to surrender its domination of Lebanon and its influence over Palestinian radicals. The conservative clerics who still hold the reins of power in Iran see themselves as locked in an elemental struggle against secularising reformists. Showing weakness to America, they fear, could tip the balance, and thus extinguish the dream of an Islamic utopia.

So it was that, before the war on Iraq, Syria's foreign minister said his country had a national interest in expelling the invaders. Hassan Nasrallah, the charismatic radical who leads Hizbullah, gave ominous warning that the Americans would face the same gritty resistance from Iraqis that bled Israel when it occupied Lebanon. Iranians spoke of Iraq becoming a swamp that would drown American ambitions.

While careful not to provoke America overtly, the allies even moved to ensure such predictions came true. Syria encouraged *mujahideen* volunteers to travel to Iraq and defend its Baathist regime. It opened its borders, letting arms supplies trickle to Baghdad, and later giving refuge to fleeing Iraqi Baathists. Iran beamed constant and effective propaganda at the Iraqi people, casting America as a brutal conqueror bent on devouring their country. The opposition groups that it backs, returning to Iraq from

long exile in the Islamic Republic, hammered home the same message while mobilising support among Iraqi Shias for clerical rule.

The swift fall of Saddam Hussein has dampened, but not extinguished, the hope that Iraq will in the end prove a costly debacle for America. Iran's and Hizbullah's hardliners still rail against America's arrogance and treachery. More quietly, old-school Baathists in Syria follow suit.

Yet the old allies are also feeling the heat. Syria has quickly moved to accommodate American demands. Wanted Iraqis are now routinely handed to American forces. The Damascus offices of Palestinian groups such as Hamas and Islamic Jihad have been muzzled or closed.

Bashar Assad, Syria's president, recently stated, for the first time, that he would accept whatever peace deal the Palestinian people approve. He has also affirmed that his support for Hizbullah extends only to its “defence of Lebanon against Israeli threats”. Belatedly and frostily, Syria has endorsed the American-sponsored road map to an Israeli-Palestinian peace. Its foreign minister even listened politely to a speech by his Israeli counterpart at last week's gathering of European and Middle Eastern ministers.

Protesting, but not listened to

Iran, faced with more direct American threats and a suspension of secret talks, has also shown some caution. Charged in the wake of the terrorist bombing in Riyadh with harbouring al-Qaeda operatives, it said the wanted men had all been arrested, pending further investigation.

President Muhammad Khatami, feted by Hizbullah during a recent trip to Beirut, insisted that Iran wanted to avoid any escalation of tension in the region. He has also insisted that Iran has no designs on Iraq, and that Iraqis should be free to elect whatever government they choose. But Mr Khatami represents only part of Iran's fractious ruling establishment, with little control over such things as intelligence operations or the ambitious nuclear programme that is a particular concern for America.

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Israel and the Palestinians

A new, flickering hope

May 29th 2003 | JERUSALEM
From The Economist print edition

Could George Bush's personal involvement light the darkness?

Get article background

DOES Ariel Sharon mean what he sometimes says? This riddle, intriguing for years on a hypothetical level, has taken on urgent significance with Israel's acceptance of the American-sponsored “road map” designed to produce a two-state peace between Israel and Palestine. Mr Sharon rammed the map through his right-wing cabinet on May 25th, leaving some of his supporters aghast by his deliberate use of the buzzword “occupation”.

“He might as well cross the road from his house and join the [peacenik] Women in Black demonstrating against him,” one settler leader wailed. The progenitor of the settlements, said another, was about to destroy his own creation. The road map requires Israel immediately to dismantle new settlement outposts erected since March 2001, and to freeze further building in all the settlements.

AFP

Sharon too is a peacenik, say critics

It also requires the Palestinians to reform their government, which they have begun to do, and to crack down on terrorism, which they have not as yet. The settlers, and their rightist and religious hinterland, had been confident that Palestinian non-performance would see off the road map, and render Mr Sharon's sometimes disturbingly peacelike words reassuringly ephemeral. Now they are not so sure.

For the first time George Bush is investing presidential prestige in a direct and personal way in the politically dangerous pursuit of peace in Palestine. A three-way summit is planned in Jordan next week between Mr Bush, Mr Sharon and Mahmoud Abbas, the new Palestinian prime minister who is still more commonly known as Abu Mazen. Demonstrating the president's determination, his senior aides gave fairly short shrift last week to a list of 14 “reservations” to the road map that Mr Sharon's team submitted.

These comprise an Israeli gloss on the document. After haggling, all the Americans agreed to say was that they would “fully and seriously address” Israel's “real concerns” once implementation of the road map was under way. But they demanded that Mr Sharon now accept it, and get his cabinet formally to endorse it.

With the reservations intact, Mr Sharon was able to woo several waverers among his own Likud ministers. Close relations with America, he argued in cabinet, were Israel's highest strategic priority. The economy, too, would never get right without a political solution. It was wrong, he went on, for Israel to maintain its forcible occupation over 3.5m Palestinians. “That's what it is,” he told a querulous Likud faction meeting in the Knesset next day. “It's occupation. You may not like to hear that word, but that's what it is.”

In the event, the cabinet vote was a comfortable 12 in favour, with seven against and with four Likudists abstaining. The two far-right coalition partners, the National Union and the National Religious Party, said they were staying in the government even though they opposed the road map vehemently, because to leave would open the way for the Labour Party to join.

The arguments that he made and the language that he used are the stock-in-trade of the peace camp,

and Mr Sharon plainly was using them advisedly. Later he backed off a bit, explaining that the Palestinian people were occupied, whereas the land itself was “disputed”. But the settlers were unimpressed with this casuistry. Mr Sharon has long spoken of his readiness to make “painful concessions”. They fear the pain will be theirs.

Mr Abbas is less certain. “I'll believe [Mr Sharon] only when he implements the road map,” he told *Haaretz*, an Israeli paper, on May 28th. “The implementation is the only test.” He said the Israeli reservations were irrelevant so far as he was concerned, and indicated that the Americans had advised him to ignore them.

Pushed by all sides to end Palestinian violence, Mr Abbas is seeking to secure a ceasefire that is accepted, even if not explicitly, by the Islamist military factions. After meetings in Gaza, the Islamists' message to Mr Abbas seems to be yes to a mutual ceasefire, no to a unilateral one. “If Abu Mazen comes back from Sharon with an end to the assassinations and the raids [into Palestinian areas], we will not embarrass him,” said Ismail Abu Shanab, a Hamas leader in Gaza. If not, the “resistance” will continue, witness the blitz of suicide bombings that rocked Israel in May.

In the past Israel has ruled out a truce, claiming that it would be a ruse to allow Hamas and the other militias to replenish their firepower. But recently Mr Sharon has floated the kite of a “temporary” ceasefire, followed by vigorous Palestinian action against the militias. Mr Abbas badly needs this reprieve, partly to rebuild his all but destroyed police forces.

More important, an end to the Israeli incursions, assassinations and house demolitions would give tangible proof to Palestinians that the road map is something more than words on paper. For the first time since the *intifada* erupted in September 2000, there are solid Palestinian majorities wanting to exchange the blood of revolt for the quiet of negotiations. But their support is conditional on Israel withdrawing from Palestinian cities, freezing settlement construction and returning a degree of normalcy to Palestinian life. Without these the *intifada* will continue, and be directed not only against Israel.

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Arrests in Saudi Arabia

Website peril

May 29th 2003 | JEDDAH
From The Economist print edition

Cracking down on al-Qaeda suspects

CONTINUING their pursuit of extremists, long nurtured in the royal family's backyard, the Saudis this week arrested five alleged al-Qaeda members in the holy city of Medina. The five, caught in an internet café, are thought to belong to the al-Qaeda cell whose 19 members escaped from Saudi security forces after their hide-out was raided on May 6th, a week before the Riyadh bombing on May 12th.

They include Ali Abdul Rahman al-Ghamdi, alleged to be the mastermind behind that bombing. While on the run, Mr Ghamdi posted a letter on an Islamist website saying that he was not part of the group, though he sympathised with its “martyrdom operation”.

Another eight al-Qaeda sympathisers were said to be on the run in Medina. They included three self-appointed religious leaders, from the kingdom's Wahhabi heartland, who had issued a *fatwa* stating that all Saudis should give assistance to the 19 al-Qaeda suspects. Unconfirmed reports said that two of the three clerics had been shot dead in a gunfight.

But there are still stern limits on taking on the Islamists: Jamal Khashoggi, the editor-in-chief of *Al-Watan*, Saudi Arabia's leading reformist daily, has been sacked. His crime? To have criticised the kingdom's religious police.

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Shia renaissance in Iraq

God liberated us, not Mr Bush

May 29th 2003 | KARBALA AND NAJAF
From The Economist print edition

A looming clash between America and Iraq's reawakened Shias

THE old aphorism “Cairo writes, Beirut publishes, and Baghdad reads” once again rings through Iraq's holy cities. Bookstalls have multiplied, peddling photocopied confessions of Saddam Hussein's former intelligence chiefs, often brought out chapter by chapter for those who cannot afford the whole text. A profusion of newspapers sell by the page, or even the article.

Religious tomes arrive from Beirut by the lorryload, among them “Mafatih al-Janan”, the manual of Shia ritual for which a Karbala bookseller, Muhammad al-Bazzaini, was sentenced to eight months in Baghdad's Abu Ghraib jail. He reveals the concealed cupboard where the secret police found his stash of sacred texts.

For over a generation, the Baath led a war on the Hauza, the religious colleges running Shia affairs. Clerics accused of Persian origins were expelled. Others were slaughtered, imprisoned with their families or forced underground. The colleges padlocked their gates. By the mid-1980s, say clerics, students at the sole functioning Hauza in Najaf could be counted in hundreds. And after the 1991 uprising, the clerical quarter between Karbala's two shrines was bulldozed, and a park built on the rubble of its seven ancient schools.

Now, nearly two months after the war, Najaf's secret scholars have emerged from the woodwork to prepare for the return of Shia luminaries from their exile in the Iranian city of Qom. Sobbing exiles lug suitcases round the shrines, as Farsi again echoes through the mosques. Taqi Mudarassi, forced out of Karbala aged 28, has returned from Tehran a grand ayatollah, and this month opened two schools for 300 students. Shia mosques soak up the armies of unemployed with a promise to pay stipends to cover living expenses after three months of tuition. Najaf, say the clerics, already bustles with 3,000 students.

America's overthrow of the Baath is spawning a Shia renaissance, not entirely to America's liking. The explosion of religious zeal has spilled into politics beyond the control of Grand Ayatollah Ali Sistani. Each ayatollah seems to have his own weekly paper, party, and real estate.

From its base in a hotel in Najaf, Hizb al-Dawa, a Shia party that has opposed the Baath since the 1960s, sends out its cadres to pin notices from its Lebanese offshoot, Hizbullah, on the walls of Imam Ali's shrine. To a man, the clerics deny any ties to the Americans, and contest their right to govern Iraq. The multiple-stabbing of Abdul Majid al-Khoei, the respected son of an ayatollah who was flown from London to Iraq in a CIA plane, was a lesson to would-be collaborators. God not Mr Bush liberated us, say clerics.

The Americans say that an Islamist state will not be tolerated. Is a clash inevitable? Disciples of one of Iraq's more excitable sects protest at the arrest of armed preachers who hailed the emergence of Khomeini-style rule. But for now, say the ayatollahs, the time is not ripe for *jihad*, or even, add some, America's departure.

Prominent ayatollahs talk of reform, including the opening of Hauzas for women. Najaf's clerics, looking for new projects in which to invest their tithes, outline plans for a religious university with science and medical faculties, and for the launch of satellite Hauza TV. The clerics are also putting out feelers to the secular world, though the dialogue is sometimes strained. Ayatollah Mudarassi, with his strangely straggly beard, invited the president of Karbala's university, twitching a fine moustache, to a cross-legged meeting on a mat. The president left loaded with books on Islamic law for his library, wary that he had accepted a Trojan horse for the takeover of his law faculty, if not his campus.

American commanders say that Karbala is their best-run city in central and southern Iraq. Could

something positive emerge from America's occupation of the font of Shia Islam? In Najaf, where Ayatollah Khomeini studied with his Hizbullah classmates, American marines now take crash courses in the local faith. Resolution of the long enmity between America and Shia Islam might be too ambitious, but knowing each other is a start.

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Iraq's mass graves

As the horrors are unearthed

May 29th 2003 | KARBALA
From The Economist print edition

Saddam Hussein's awful legacy

AFTER cradling one of the 475 white nylon sacks laid out on the concrete floor, Um Jassim opens the shroud and sifts through the bones. She strokes a bone attached to a blindfolded body, and kisses the teeth. My only son she wails, beating her chest. Bring him back.

The unearthing of Saddam Hussein's mass graves has barely begun. But already the roads are full of taxis with makeshift coffins stuck to their roofs, heading for the world's largest cemetery at Najaf, where Shias bury their dead. The bodies date back two decades, from 1980, when membership of some Islamic groups carried the death penalty, to an uprising in March 1999. Parents scour the lists pinned to the walls of youth centres and mosques. Some return home with a sack in the boot of their car, a few carry a body home. But most of the bodies remain unclaimed.

A British forensic team is visiting Iraq, hoping to match the DNA of the dead with the DNA of the missing. Many have been identified by their clothes, says an announcement on Najaf television. The revelations feed the desire for revenge. Every mosque is plastered with photographs of missing people, men and women. Human Rights Watch puts the number of missing at 290,000.

Some of the bodies appear to have been caught in the crossfire of Iraq's wars. Many were deliberately massacred. One man recalls a day in 1991 after the Shia uprising was suppressed. The Republican Guard trawled through the town with loudspeakers, summoning men aged 17 to 70 to gather at a crossroads on the outskirts to meet Hussein Kamel, the president's son-in-law. When they arrived, 17 were immediately shot. Hundreds more were packed into 40 buses waiting at the side of the road. When the buses had filled up, soldiers flagged down empty lorries and piled the remaining men in. He alone, he says, managed to jump off when the lorry stopped at a traffic light.

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Iraq's antiquities

Mesopotamia's vanishing treasures

May 29th 2003 | UMMA
From The Economist print edition

Looting at remoter archaeological sites continues relentlessly

SAFEGUARDS, carried out by the coalition and bolstered by local watchmen, have put a stop to the looting of Iraq's priceless archaeological sites. Or so said Pietro Cordone, the suave Italian who has been appointed to look after Iraqi culture, on May 18th. Mr Cordone is not telling the truth.

On May 25th, this correspondent visited the partially excavated site of Umma, one of the world's earliest known city states, in the southern province of Dhiqar. Some 100 looters were visible, many digging on the tell. Others, according to locals, were dotted round the sprawling site. Looting at Umma has now entered its second month.

Before the war, 116 watchmen did a reasonable job of protecting hundreds of sites across the province. Now, they are powerless to prevent the invasion by armed gangs, up to 200-strong, often accompanied by dealers in jewellery and cuneiform seals. Provincial officials know for sure of six important sites that have been looted, or are being looted; the real figure is certainly much higher.

Adel Amir al-Hamdani, who oversees monuments across Dhiqar, notes that the remains of palaces and temples, some dating from the third century BC, have been obliterated in the frenzy. Local labourers may have guided gangs to some places, but the looting of unexcavated sites, whose existence is largely unknown, suggests expert collusion.

Iraqi officials accuse Dhiqar's American administrators of indifference to the unfolding catastrophe. On May 23rd, people near Umma saw two American helicopters land, scattering the looters. The pillagers returned 20 minutes later, after the helicopters took off.

Jon Anderson, an American major stationed near the celebrated site of Ur, describes efforts taken during the fighting around Ur's ziggurat, to prevent vandalism “that could have been blamed on the coalition.” A serviceman, caught prising a brick, has been disciplined. If only this vigilance was being extended to Mesopotamia's less visible treasures.

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Rwanda's new constitution

The fear of majority rule

May 29th 2003 | KIGALI
From The Economist print edition

Rwandans vote for the ruling party's so-so idea of democracy

Get article background

AFP

Will she get what she wants?

NOTHING was left to chance. To make sure that the referendum to approve the new constitution went smoothly, Rwandans were given time off work to register to vote. Nearly 4m—over 95% of eligible adults—did so. On the day itself, May 26th, shops and offices were closed, and the government requisitioned vehicles from foreign aid groups to ferry ballot boxes around. Rwanda's president, Paul Kagame, likes things to run like clockwork, without surprises. And indeed, there was nothing surprising about the result: from an 87% turnout, 93% put their thumbprint in the box marked "Yes".

The purpose of the new constitution, a product of nearly two years of reasonably transparent debate, is to allow more democracy without inviting another genocide. It seeks to do this by ensuring that neither of the two main ethnic groups, the Hutus or the Tutsis, can wholly dominate the other. Multi-party elections, Rwanda's first since the 1960s, are to be held later this year. No matter how people vote, the constitution stipulates that no party may hold more than half the seats in the cabinet. It also states that the president and the prime minister must be from different parties.

Without such checks, democracy would probably give the Hutus, a large majority of the population, a permanent monopoly of power. Tutsis, such as Mr Kagame, shudder at this notion. Understandably so: the last Hutu-dominated government tried to exterminate them all. The trouble is that the system can function only if the parties themselves are healthy and free. And they are not.

The new constitution forbids parties from organising at grass-roots level—but the ruling party, Mr Kagame's Rwandan Patriotic Front (RPF), is hardly affected, as it already has a mighty field operation, which it fine-tuned during local elections in 2001. Moreover, the government has, in effect, banned its only serious rival. In December, a parliamentary investigation was launched to determine whether the Democratic Republic Movement (MDR) was guilty of "divisionism", the catch-all term for encouraging citizens to think of themselves as Hutus or Tutsis first, and Rwandans second. A 1,000-page report concluded that it was.

This is unfair. Although the party is largely Hutu, and a breakaway MDR faction did participate eagerly in the genocide, the MDR today is quite respectable. Mr Kagame used to think so, too: his party has governed in coalition with it since 1994. Nonetheless, on April 15th parliament voted to dissolve the MDR. The party will probably not survive the summer.

The RPF, meanwhile, is signing up new members at an impressive pace. Its powers of patronage are one attraction, but so, according to Human Rights Watch, a lobbying group, is a widespread fear that those who do not join will be labelled "divisionists". There is no official sanction for this, of course, but at least seven prominent dissidents have disappeared recently.

One, Leonard Hitima, an MDR deputy who was preparing to defend the party against dissolution—and who happens to be a Hutu who saved Tutsis during the genocide—vanished in early April. His car turned up near the Ugandan border. The government suggested that he had defected to Uganda, Rwanda's arch-rival. Maybe, but previous defectors have typically made public their reasons for fleeing.

By the standards of previous regimes, the RPF is not unduly repressive. Juvenal Habyarimana, a happily dead dictator, decreed that all Rwandans had to join the ruling party, even babies. The RPF is prepared to allow a measure of pluralism, but not, it seems, to lose power. The new constitution allows the next president, who will surely be Mr Kagame, a seven-year term, renewable once. Mr Kagame says he argued for this to be reduced to five years, but what can a man do?

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The European Union's constitution

Tidying up or tyranny?

May 29th 2003 | BRUSSELS
From The Economist print edition

Writing a constitution for Europe has been fraught. But the European Union's countries fret about very different things

Get article background

FOR Valéry Giscard d'Estaing, chairman of the convention on Europe's future, the European Union's draft constitution that he unveiled on May 26th presents a unique chance to set the EU's course for the next 50 years. For Peter Hain, the British government's man at the convention, it is a mere “tidying-up exercise”—consolidating generations of EU law into a single, comprehensible document. For Britain's *Daily Mail*, the draft is a “blueprint for tyranny”. But for Elmar Brok, a German member of the convention and an ardent federalist, it is an “extraordinary disappointment” and an unravelling of the federalist dream. And Romano Prodi, the European Commission's boss, moans that the draft “lacks vision and ambition”.

Such differing reactions reflect the political prejudices of the speakers and the difficulties of understanding the complexities of a constitution that runs to several hundred pages and covers topics as diverse as human rights, the political institutions of the Union and social policy. But it also reflects a fundamental ambiguity about the nature of the enterprise. Mr Giscard d'Estaing and his cohorts are writing a “constitutional treaty”. A treaty is generally concluded between states; a constitution is generally adopted by a state. The fact that the EU is adopting a constitutional treaty underlines its hybrid nature, half-way between an international organisation and a state.

Mr Hain has half a point when he speaks of a tidying-up exercise. Around three-quarters of the clauses in the proposed new constitution are simply adopted from previous treaties. But even some of the rights long ago accrued by the EU have the capacity to shock when written down in black and white. Professional Europeans point out, for example, that Article 10 of the constitution, which states that EU law “shall have primacy over the law of the member states”, is just a restatement of something that has been true since the Treaty of Rome in 1957.

Indeed, if European law did not override national laws, the EU's whole internal market would grind to a halt. But in Downing Street they are uncomfortably aware that polls suggest that only 10% of the British people accept the proposition that EU law should override British law. It is rather as if, having happily consumed factory-made sausages for 30 years, consumers are now being asked to read the ingredients

on the side of the packet and consider carefully if they want to keep eating reconstituted udders.

It is also true, however, that the other 25% of the constitutional treaty contains a lot of innovation: the adoption of a charter of fundamental rights, the expansion of the EU into the field of criminal law, the creation of an EU foreign minister and an armaments agency, an extension of majority voting into such sensitive areas as farm policy, regional funds and asylum, as well as big reforms of EU institutions.

The widest expansion of the EU's powers would come in the field of legal systems. The constitution proposes creating a category of serious cross-border crimes, such as corruption, fraud and people-trafficking, which could be pursued by a European prosecutor and which would require at least a degree of harmonisation of national criminal codes.

The British are uneasy and they are not alone. Gijs de Vries, the Dutch government's representative at the convention, argues that, if the current proposals go through, “the vast majority of national criminal law will have to be harmonised in the very near future...harmonisation of national law cannot be limited to mutual assistance in combating crime. The unintended side-effect is that it almost always affects other aspects of criminal law.” As Mr de Vries also notes, “the criminal-justice system constitutes a central element of each society” and reflects its national character—just think of liberal Dutch laws on drugs—which might have to change under a new system.

Too many rights

The incorporation of the charter of fundamental rights into EU law, as part two of the draft constitution, has even more profound implications. For countries like Britain and Ireland with a common-law tradition, where rights are entrenched by legal precedent and by the absence of legislation prohibiting activities, the declaration of a positive list of rights marks a deep legal change. The British also worry that the list of rights includes a lot of vaguely worded social rights, including a right to work, bargain collectively and strike, and a right for workers to be informed and consulted about big managerial decisions. They fear that such rights could be used to roll back Thatcherite labour laws which have let Britain avoid some of the rigidities of continental labour markets. What if the unemployed sued the government for violating their right to work or if factory closures were stopped because workers had not been consulted?

The constitution made simple (up to a point)

	What it contains	The latest state of play
The preamble: A grand declaration	The purposes and establishment of the European Union. Valéry Giscard d'Estaing, the convention's chairman, hopes it will be an inspirational text learnt by schoolchildren across the Union	Mr Giscard d'Estaing has published a draft lauding Europe's "cultural, religious and humanistic inheritance" and asserting the goal of "ever closer unity"
Part One: The constitution's central legal principles	The establishment of the Union, its values, the status of European law, the distribution of powers between the nations and the EU, the EU's institutions, and procedures for leaving the Union. All already published and revised once, except for proposals to alter the mechanics of the institutions (eg, the number of commissioners, the size of parliament, the presidency of the council)	The convention will probably spend the next three weeks, before the EU's leaders meet in Salonika, Greece, on June 20th, battling over the institutions; they may fail to agree on a single text. Other tricky bits of Part One may be revised by the inter-governmental conference (IGC) of EU leaders starting in September
Part Two: A Charter of Fundamental Rights	Mr Giscard d'Estaing wants to incorporate it into law as part of the constitution. It was already agreed in outline at an earlier convention	Some countries, led by Britain, are wary but will agree if they can attach an "interpretative text" that limits its impact on domestic law. Expect it by June 20th
Part Three: The policies	The grand declarations laid out in Part One are fleshed out in detail. The EU's reach into criminal law, taxation and social policy (among other things) is defined	Many battles still to be fought before June 20th and in the IGC thereafter
Part Four: Procedures for ratification	The constitution is to replace all previous existing EU treaties, raising the possibility that a country failing to ratify it might have to leave the Union. As drafted, it can come into force only if all member countries ratify it; there is no legal base, as yet, for expelling non-ratifiers	Federalists are fuming

The timetable

From now until June 20th the convention faces three long sessions, ending, propitiously, on Friday June 13th. Final draft to be presented to EU leaders' summit in Salonika, on June 20th.

In September, an IGC conference of the leaders of the 15 EU countries and ten new ones expected to join in 2004 start revising the text. Mr Giscard d'Estaing hopes the IGC will do little to revise it. So does Italy's government, since it hopes to relaunch the EU with a grand new Treaty of Rome at a summit scheduled for December 2003. Both parties are liable to be disappointed: the IGC may well drag on for at least six months.

Ratification

If and when the leaders finally agree on a text, all 25 EU countries must ratify it over the next two years, some with referendums, others only by votes in parliament. If too many big countries fail to ratify, the constitution could die.

The British believe they can safeguard their position if they can get an explanatory commentary, limiting the charter's impact on national legislation, attached to the constitution. But it is not clear they will succeed in this, though they have support from the Irish, Danes, Dutch and Italians.

Remembering Iraq

Many of the most fraught debates in the convention have centred on foreign policy and defence, reflecting the splits caused by the Iraq war and the aspirations of those who hope to see the Union develop into a counterweight to the United States. Here, Mr Giscard d'Estaing and his presidium are fairly cautious. It is true that the constitution calls for member states "to actively and unreservedly support" a common EU foreign policy and "refrain from action contrary to the Union's interests". But all this language is from existing treaties and did not prevent the various EU countries going their own sour ways over Iraq.

The creation of a European foreign minister sounds dramatic but it is essentially a merger of two existing jobs, without giving the new post-holder any new powers to impose a single policy on EU countries.

Crucially, countries keep their national vetoes over key foreign-policy decisions. The decision to grant the EU “legal personality” does mean it can now negotiate and sign treaties and could theoretically take a seat at the UN. There is no mechanism for compelling France and Britain to give up their permanent seats on the Security Council in the EU's favour.

The national veto is also retained over the other neuralgic issue for the British and Irish: taxation. Mr Giscard d'Estaing has acknowledged privately that any move towards harmonising taxes would make the Irish refuse to ratify the treaty. Even so, the Irish and the British will still seek to tighten the language to avoid even a hint that taxes might one day be set by majority vote. They might also gulp at the draft's suggestion that the EU should raise its own budget, which implies that the Union should gain the right to raise taxes.

Looked at overall, the constitution does mean a further transfer of power to Brussels. National vetoes are abolished over some 20 new subject areas, including aspects of immigration and social policy. On the other hand, there is an attempt to give national parliaments stronger rights. Under new provisions under the rubric of “subsidiarity”, if a third of national parliaments believe that a proposed EU law exceeds the Union's powers, they can force the European Commission to reconsider—but not necessarily to block. And they can ultimately ask the European Court of Justice to adjudicate.

Small concerns

While the balance of power between nations and the EU dominates debate in Britain, in much of the rest of the Union the most controversial issue is Mr Giscard d'Estaing's plan to reform European institutions. The convention's chairman believes that the current balance of power within the EU gives far too much power to small countries. His aides point out that in an enlarged EU of 25 countries, the seven smallest ones representing a paltry 1.5% of the EU's GDP will have more voting weight in the European Commission than the six largest countries with 82% of the Union's GDP.

Mr Giscard d'Estaing proposes to drop the principle that every country has a right to a European commissioner with a vote. He wants a slimmed-down commission with 15 members and perhaps 15 non-voting “advisory commissioners”.

He also suggests making representation in the European Parliament more proportional to population; at present it takes ten times as many votes to elect a German MEP as to elect one from Luxembourg. Most controversially of all, he wants to abandon the system under which each EU country holds the Union's presidency for six months at a time, in favour of a president in office for up to five years, elected by heads of government.

These ideas have been greeted extremely frostily by the “smalls”. One European commissioner from a little country says Mr Giscard d'Estaing has only two aims, “to deliver power to the big countries and to screw the European Commission”. The smalls are insisting that every country should retain a commissioner; most reject the idea of a longer-term holder of the EU's presidency, which they say could undermine the commission.

It is these issues, rather than the arguably more fundamental questions of the balance of power between the EU and the nation-states, which are likely to provoke the most passionate debates in the convention's last three weeks. They could yet even destroy the whole enterprise.

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Russia

The secret policeman's ball

May 29th 2003 | MOSCOW
From The Economist print edition

Russia has a chance to show off its president's mixed achievements

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LIKE a flustered society debutante putting on every single piece of jewellery she can find, Russia is desperate to look her best for the 50-odd foreign leaders expected on May 30th in St Petersburg. Celebrating its 300th anniversary, the city will glisten with fresh paint and new gold leaf (though the bright facades, like most ball dresses, conceal flimsy supports and hasty fixes). Unsightly birthmarks, such as the vegetable patches of people living in sight of the Konstantinovsky palace where the leaders will gather, have been forcibly removed. Even body odour will be banished: the authorities have encouraged locals to leave the city for the weekend.

And, as at any coming-out party, young Lady Russia's conversations will be charming but inconsequential. In a separate meeting with European Union leaders, Vladimir Putin, Russia's president, is to discuss a common economic area and visa-free travel, but those are distant goals. Expect even less from a summit with leaders of the Commonwealth of Independent States (minus the three Baltic ones) that emerged from the old Soviet Union. Russia this year gave up the CIS presidency for the first time, letting Ukraine's Leonid Kuchma be “elected” to the job, showing just how irrelevant it now considers the CIS to be.

So the event is truly a chance for Vladimir Putin, Russia's president, to show off how well the debutante is doing. Adolescent Russia has been putting on a growth spurt. As the rest of the world totters, last year's GDP grew at a perky 4.3%. In April most analysts began predicting even faster growth this year, thanks mainly to high oil prices and unexpected productivity gains.

Mr Putin, who became president just as Russia was recovering from its 1998 default, can take some credit. He has pushed through tax cuts. Bureaucratic reforms, though limited, have made things easier for business: a study sponsored by the World Bank found that small businesses now rate each other's competition, rather than bureaucracy, as their biggest challenge. But Mr Putin's main feat—though no small one—has been to bring stability.

That is thanks partly to his taste for control—he has strengthened his direct powers over those of the legislature and regional governors, and put a lot of former secret-service colleagues in key posts—and partly to his own knack of looking like the calm point in every storm centre. He makes sure to appear separate from his government and is often seen on television berating officials for not being up to scratch. His control over the media helps too. This year Freedom House, an American think-tank, downgraded Russia's media status to “Not Free” after the last more-or-less independent national television boss, Boris Jordan, was squeezed out of the best state-owned channel, NTV.

As a result, when things go wrong, polls find that public opinion turns against ministers or against the pro-Kremlin political party, United Russia, but that the president's own rating has barely flickered. Nor does the bloody war still grinding on in Chechnya, where a fortnight ago nearly 80 people were killed by suicide bombers, seem to dent Mr Putin's popularity much.

Tsar Vlad, again

This, and the fact that there are no other plausible candidates, makes Mr Putin's re-election next year very likely. United Russia's chances in December's election for the Duma, the lower house of parliament, are less clear. But the Duma is becoming a parody of a parliament anyway, with business moguls falling

over themselves to bankroll political parties and ensure friendly voting blocks. Mr Putin's sway over the Duma will depend more on his negotiating skills after the election than on campaigning before it. The real question is whether in a second term he will push through knottier but delayed reforms such as a revamp of the bloated armed forces.

But if he is secure at home, Mr Putin is on shakier ground abroad. His criticism of the war in Iraq hurt his warm relations with George Bush, and there has been much hand-wringing in both Moscow and Washington about how to restore them.

This, though, is the least of problems. American officials have been admitting that the policy, in a well-worn phrase, is to “punish France, ignore Germany and forgive Russia” over Iraq. Mr Bush will sit down with Mr Putin for 45 minutes in St Petersburg but will, it is said, avoid France's Jacques Chirac. (Then they will all fly to the French town of Evian for a meeting of the leaders of the world's eight rich countries, Russia politely included.)

The fear is not that Messrs Putin and Bush will find it hard to talk, but that there is little left to talk about: the main argument over Iraq is over, the delayed Moscow treaty on disarmament has been ratified, and Russia is said to be paying more heed to American worries about its support for Iran's nuclear programme. Officials are casting about for new subjects—the war on AIDS, perhaps, or the space programme?—to fill the bilateral agenda.

Much trickier are relations with the EU. After next year's enlargement it will account for over half of Russia's trade and provide many more complex issues—trade tariffs, visas, border security, energy prices, and so on. Russia's dark human-rights record matters more to the Europeans too. Russia and the EU, says Fyodor Lukyanov, editor of “Russia in Global Affairs”, need a permanent co-operation body. Otherwise Russia may risk being the eternal debutante: chattering prettily to all her suitors, but never getting very far with any of them.

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Turkish delight

Every Euro-way they can

May 29th 2003
From The Economist print edition

Why Turks think their lady won the Eurovision Song Contest

AFTER decades of pounding on Europe's door, Turks were wildly celebrating their first-ever victory in the Eurovision Song Contest held in Latvia's capital, Riga. Their joy was bolstered by the concurrent news that a brooding Turkish film, “Uzak”, (meaning “distant” in Turkish) had won a top prize at the Cannes Film Festival. And only a week before, Orhan Pamuk, Turkey's best-known living writer (alongside Yasar Kemal, a venerable Kurd), had won one of the world's richest literary awards, the IMPAC Dublin prize. This flurry of success loosed a tidal wave of punditry.

The brightest spotlight fell on Sertab Erener, whose winning song, “Every way that I can”, was a catchy mix of oriental sound and western pop. Some seriously opined that her victory, after 28 years of mostly very meagre results, was a sure sign that the European Union was ready to admit Turkey after all. Others said it was because of a Turkish-inspired decision to open the borders between the two parts of Cyprus for the first time in 29 years; why else had the Greek-Cypriot viewers given the Turks a generous “huit points” after decades of “nul”?

No, explained the sages of the left, it was because Turkey had refused to let American troops use Turkish soil from which to attack Iraq. And did not the peace-loving voters punish the bellicose Americans' best friends, the British, with a derisory “nul points” to Turkey's 167?

Disgusted by Ms Erener's belly-dancing kit, Islamists had another view. She was allowed to win, they mournfully surmised, because she had capitulated to the West by singing, as no Turkish competitor had done before, in English.

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France on strike

Crunch time

May 29th 2003 | PARIS
From The Economist print edition

In the government's pension-reform campaign, the moment of truth is close

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AP

Boohoo, says the government

DEPENDING on the day of the week, France's teachers are either on strike or demonstrating in the streets—or both. So, too, air-traffic controllers, tax-collectors, hospital workers, postmen and soon, it seems, the dustmen of Paris. All of which most French people will consider is par for the course: the government of Jean-Pierre Raffarin is committed to reforming a financially unsustainable pension system that favours the public sector over the private—and the public sector is determined not to lose its privileges. Hence the current trial of strength. “The street can give its views,” is the mantra of Mr Raffarin, “but the street does not govern.”

One way or another, the proof of the prime minister's argument will come soon enough. The holiday season is approaching for everyone, politicians and workers alike, and if the issue is left unresolved, the government risks losing both its momentum and its credibility. That is why the unions, who now represent only about 13% of the workforce but have a power and popularity far beyond their numbers, are stepping up the pace. A general strike has been called for June 3rd, a week after the government confirmed its pension plan and a week before the plan gets its first hearing in parliament. Fast forward to the end of June and parliament will end its working session (unless President Jacques Chirac decrees otherwise) and the nation's students will have taken their exams (unless their fractious teachers make it impossible, an outcome which might finally provoke a popular backlash).

So which side will win? Government ministers bemoan the opportunism of the opposition, which knows reform is necessary but failed to take action when in power between 1997 and 2002. They bemoan, too, the way workers who are not directly affected by the reform—the railwaymen, for example, have been carefully exempted—nonetheless go on strike. And they complain that some issues are being maliciously confused. Why do the teachers, for example, lump pension reform together with the decentralisation of education, a process which will apply not to them but to their support staff?

In the end, the result may depend on President Chirac himself. So far, he has been pretty reticent, remarkably so given that in his re-election campaign last year he emphasised the need for reform. The betting, however, is that he will speak out on July 14th, when France celebrates its revolution and the storming of the Bastille. What better occasion for the president, who has a way with words, to explain to the people the need for reform to preserve what the French like to call “solidarity between the generations”? What a pity that in the meantime so many non-strikers have had to suffer. And what a paradox that a majority of these suffering non-strikers apparently still support the strikers' demands.

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Spain's elections

The government keeps its end up

May 29th 2003 | MADRID
From The Economist print edition

The ruling conservatives did better than expected in the latest elections

AGAINST pollsters' guesses, Spanish voters delivered the mildest of rebukes to Spain's conservative prime minister, José María Aznar, in regional and local elections on May 25th. Mr Aznar's mishandling of the *Prestige* oil-tanker disaster, his hugely unpopular pro-American stand in the war against Iraq and his authoritarian style of leadership had helped to give the opposition Socialists an opinion-poll lead of some six percentage points. In the event, they barely nosed ahead. For a mid-term election after seven years of governmental wear and tear, the result was a mighty relief for Mr Aznar's People's Party (PP). Unless things go badly wrong in the next year, it has a fair chance of keeping power at the next general election, due by March. In any event, it is likely to be a close contest.

Mr Aznar led from the front, displaying his old resilience. His campaign was highly personal. True, the Socialists bucked a ten-year trend by winning more votes than Mr Aznar's People's Party. But it was far from being the electoral *castigo* (punishment) they had hoped to inflict.

Only 200,000 votes out of more than 23m cast separated the two main parties. The PP was a single percentage point down on its previous election showing in local and regional elections, in 1999, with 34% of the vote to the Socialists' 35%. Looking on the bright side, Mr Aznar declared that his party “now has more mayors and more local councillors than any other”. His PP not only held its old bastions but even stormed a few more, such as Burgos and Granada. It did well in Valencia. In Galicia, whose coastline was besmirched by the *Prestige*'s oil, the PP got 41.5%, only four points less than in 1999.

The party's biggest swoop was on Madrid's city hall, where Mr Aznar's wife, Ana Botella, number three on the PP's slate, will now make her political début. The mayor-elect, the able and ambitious Alberto Ruiz-Gallardon, though not close to the prime minister, has suddenly emerged as the PP's new star.

Indeed, he is already being talked about as a possible replacement for Mr Aznar when he steps down from the top job, as promised, before the general election. Mr Aznar says he will name a successor within four months. There is no obvious heir. Jaime Mayor Oreja, a former interior minister, is stuck in the Basque region; Rodrigo Rato, the finance minister, has not been shining of late in the media; and the reputation of Mariano Rajoy, the deputy prime minister, was dented by the *Prestige*.

Meanwhile Mr Aznar will continue to promote the themes that evidently served him well in the campaign. He has been tough on Basque terrorism. He sounds harsh on illegal immigration. He also made some populist promises—for instance, to lower the cost of renting flats and to give tax breaks to big families. And he boasts, with good reason, of Spain's economic progress during his seven years in office. He claims that Spain's GDP per head is now approaching 90% of the EU average. (At last count the OECD put the figure at 85%, against 77% in 1996).

All the same, the Socialists' leader, José Luis Rodriguez Zapatero, called the results “a good start for 2004”. His party captured the city of Saragossa and the region of Madrid by forming a coalition with the communist United Left. It held Barcelona, the Catalan capital, won a huge majority in the backwater region of Castile-La Mancha, and retook the regions of Extremadura and Aragon.

But *El País,* the country's leading left-of-centre newspaper, said sorrowfully that Mr Zapatero, in his first nationwide campaign, had failed to capitalise on Mr Aznar's woes. His team lacks style and substance. With his moderate, consensual brand of politics, Mr Zapatero is likely to lead the Socialists into the general election. And plainly he still has a chance of being Spain's next prime minister.

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Charlemagne

How football unites Europe

May 29th 2003
From The Economist print edition

The players do better than the politicians at making Europe loved

Get article background

SOMETIMES it can seem hopeless. How do you mould a single European people out of the lumpen masses scattered across the continent? European Union citizens are stubborn homebodies: only 1.6% of them live permanently in an EU country other than their own. They still insist on speaking different languages, they read different papers, worship at the shrines of different celebrities, chortle at different television programmes. But there is one big exception. Every Tuesday and Wednesday, much of Europe's male population tunes in to watch the Champions League, the pan-European football championship embracing the best teams from all over Europe. On May 28th this year's final was in Manchester. Awkwardly for a European competition, both teams were Italian—AC Milan (who won) and Juventus. But their squads were drawn from all over the continent: France, Portugal, the Netherlands, Denmark, the Czech Republic, Georgia, Ukraine—topped up with a smattering of Brazilians.

Over the past decade European football teams have turned into a living, breathing embodiment of European integration. Clubs that once recruited fans and players from their immediate neighbourhoods now scour the continent for talent and are watched in every country. Footballing integration has both shadowed and been prompted by Europe's political and economic integration. The European Cup, forerunner of the Champions League, was first staged in 1956, a year before the Treaty of Rome gave birth to the European Economic Community (EEC). In both spheres, the British were initially stand-offish. Just as they balked at joining the EEC, so their teams refused to take part in the first European Cup, but later joined in when they saw the competition was a success.

In the 1990s, football integration in Europe leapt forward, driven directly by the expansion of European law. The free movement of labour around Europe meant it was no longer legal for football leagues in the EU to limit the number of foreigners in their teams. All EU citizens (though not all foreigners) had to be treated equally. Around the same time, the European Court asserted that footballers, like other workers, were free to move anywhere at the end of their contracts, without their old employers demanding a transfer fee. So players' wages soared and talented players headed for Europe's richest clubs. Economic liberalisation has created an elite of European teams now literally in a league of their own—the Champions League. It is no accident, given European law's role in changing football, that Europe's top clubs have set up their own organisation, the G14, in Brussels.

Romantic souls hope that integrating European football will prompt ordinary fans to start feeling more European and to dispel their clichés about neighbouring countries. Simon Kuper, a football writer, says that the best English teams' increasing reliance on continental players and managers emits a subliminal pro-European message: “Continentals aren't bad people. They can work in harmony with Britons. The continental way is more efficient...if we don't follow them we will be left behind.”

Football has probably made Britons think more amicably about their fellow Europeans than anything else in Britain. The British view of foreign footballers used to be pretty plain: Italians cheated and spent their time rolling around on the floor to earn free kicks; the French gave up if it was raining or windy; the Germans were arrogant and humourless. But then along came players like Gianfranco Zola, an Italian recently voted by the fans at Chelsea, a London club, as its best-ever player, adored not just because of his skill but also because of his sportsmanship. Across town, Arsenal are captained by Patrick Vieira, a Frenchman who is one of the toughest players in the English league (even when it is raining). His club's rival, Tottenham Hotspur, fell for Jürgen Klinsmann, a German striker, who turned out to have a self-deprecating sense of humour as well as a talent for scoring goals. Meanwhile England's Gary Lineker moved to Barcelona and showed that some Brits can learn foreign languages.

Let's keep a few enjoyable prejudices, though

But not all players reverse national stereotypes. Some are adored precisely because they confirm them. David Ginola of France won the player-of-the-year award in England—and starred in shampoo commercials. Eric Cantona, his compatriot, transformed the fortunes of Manchester United—and confirmed an old English view that Frenchmen like spouting philosophical nonsense. (Asked about a suspension for violent conduct, he remarked enigmatically: “When the seagulls follow the trawler, it is because they think that sardines will be thrown into the water.”) Meanwhile Paul Gascoigne, who played (and boozed) for England and Lazio, a Roman team, appalled Italian journalists by burping loudly into a microphone at a press conference. Luther Blissett, a centre-forward from Watford in England who moved to AC Milan, struggled with Italian culture as well as with his own limitations as on the field (“Luther miss it”), though he did achieve the rare distinction of inspiring a sect of Italian anarchists all to change their names—to Luther Blissett (see www.lutherblissett.net).

The cosmopolitan nature of the Champions League undoubtedly blurs the edges of both playing styles and fan loyalties across Europe. But the fact that teams are now so genuinely European (Chelsea have sometimes fielded sides with no British players at all) does not seem to have disturbed the way the European press writes about them. A study by Liz Crolley and David Hand, two British academics, underlines the durability of certain images. Both at home and abroad English teams are portrayed as strong in fighting spirit but short on technique; the Germans as efficient, physically imposing but unimaginative; the French as full of artistry but liable to crumble under pressure. A dreadful thought occurs. Could these clichés persist because there may, after all, be the tiniest grain of truth in them?

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Water industry

Frozen taps

May 29th 2003 | EDINBURGH
From The Economist print edition

Privatisation works. State ownership is costly and inefficient. A dip in the water north and south of the border demonstrates it, yet again

PRIVATISED in England, a mutual in Wales, a nationalised industry in Scotland and a government department in Northern Ireland—there is no better proving ground for different ideas about utility provision than Britain's water industry.

The question is a pressing one because the government has decided that it has to get bureaucrats away from Northern Ireland's costly system. The province's devolved (but currently suspended) government has been told to devise a new structure.

A few years ago, there would have been little support for privatisation. After the Conservative government privatised English and Welsh water in 1989, bills shot up, prompting a public outcry, even though most of the money was spent on modernising the decrepit and messy systems the private firms had inherited. But over time, the bills went down, while beaches and rivers have become much cleaner.

Nonetheless, Welsh water went out of private ownership in 2001, moving to a one-off mutual structure, in which it was bought with £1.8 billion ($2.9 billion) of borrowed money by a not-for-profit company owned by 200 prominent locals. Thanks to the efficient management developed in the previous years of private ownership, bills are quite reasonable.

Not so in Scotland. In the early 1990s English bills were 70% higher than those north of the border and the lesson drawn was to shun privatisation. Strathclyde Council ran a postal referendum in 1994 in which 97% of those voting rejected selling off what one MP called “God's water”. That was backed up by advice from Coopers & Lybrand (now part of PricewaterhouseCoopers) that privatisation would mean bills rising 152% over the coming 15 years, compared with only 95% if it stayed in the public sector. Since then, though, the divergence between the performance of water suppliers north and south of the border has been startling (see table). Over the past decade, Scottish household bills have gone up by 94% in real terms. English bills have gone up by only 22% since 1989.

Soaking the Scots

	England	Scotland	Wales	N. Ireland
Average household water bill*, £	236	263	277	375†
Average medium-sized office water bill*, £	1,772	28,494	1,820	643
Drinking-water quality tests passed‡, %	99.9	99.2	99.8	98.4
Sewage-discharge regulations complied with‡, %	94.0	85.0	97.0	69.0
Leakage rate, cubic metres per km of main per day	9.8	23.7	9.7	10.3

Sources: Ofwat; Environment Agency; Scottish Executive; Northern Ireland Office

*2003, FY beginning April 1st †Notional: subsidy lowers actual bills ‡2001

But the heaviest burden falls on business. A medium-sized office in Scotland pays 16 times more than its English counterpart. Big thirsty industries face a serious competitive disadvantage: managers at BP's refinery at Grangemouth in Scotland are facing a bill this year from Scottish Water for £12.7m. South of the border, the equivalent bill would be more like £7m. Moreover, BP says Scottish Water is frustrating its efforts to find alternative supplies, so it is thinking of taking the state-owned water company to court.

Small firms are just as agitated. John Downie, Scottish director of the Federation of Small Businesses, says his members are facing water bill increases of between 50% and 300% this year, taking them to between four and five times the level of equivalent bills in England. He wants a Scottish parliamentary inquiry. “This is costing jobs,” he says. Altogether, it looks as though Scottish companies are paying about £190m a year more for water than their counterparts in England.

All that might be excusable if the aquacrats were doing much better with the extra money. But in fact Scots get poorer drinking water, more pollution from their sewers and their pipes are more than twice as leaky. Private water firms beat the public sector on all counts.

What's gone wrong? After all, a publicly owned water industry does not have to pay dividends to shareholders and can borrow money at lower interest rates than private firms. “Essentially, the service was run by engineers,” says Alan Alexander, chairman of Scottish Water, a new company formed in 2002 by a merger of three regional state-owned utilities. “No-one gave much thought to economics.” Politics has also played a role. The utility has been in thrall to trade unions, so it is over-manned. And the need to keep politicians sweet may explain why business charges have risen so much faster than the domestic bills most voters pay.

Scotland's water regulator, Alan Sutherland reckons that about £86—more than a third—of the £231 average domestic bill in 2001-02 was wasted. So ministers told Scottish Water to cut its costs by 45% by 2005-06. Bills won't start coming down until 2007, though, because the company must find £1.8 billion to spend on upgrading its pipes and sewers. Scotland's costly water is a salutary reminder of the cost of the country's love affair with state provision. Better to privatise it late than never.

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Economics and reality

The Big Easy

May 29th 2003
From The Economist print edition

Stelios Haji-Ioannou is attempting to bring the dismal science to undismal life—with mixed results

AP

I'm starring in my epic

IT IS perhaps fitting that micro-economics should have one of its most interesting ideas tested in Milton Keynes, a smallish town north of London which combines (by accident) the names of two of the last century's greatest economists. The 600-odd people who went to the opening showing of easyCinema there last Friday were doubtless more interested in seeing a film cheaply (prices started at 20p) than in being guinea pigs for the theory of marginal pricing.

But it is this that fires the imagination of Stelios Haji-Ioannou, multi-millionaire, self-publicist and founder of easyCinema, easyJet, a budget airline, easyCar, a car-rental outfit, easyInternetcafé and others. As demand goes up, he argues, so should prices. So people who buy early, or choose slack times of day, get better deals. For example, charges at his internet cafés rise as the seats fill up. The more people that hire his cars, the greater the cost to the remaining customers. The first seats sold on easyJet flights are cheap, the last few the most expensive.

Although many businesses practise such “yield management”, none does it as radically as Mr Haji-Ioannou. Worked correctly, it should mean that he makes a lot more money than conventional fixed-price operators when his services are popular. Other businesses simply turn away customers when, say, the cinema showing or the flight is full. They may even lose money at peak times when they buy in extra capacity to provide customers with the service they want at the promised price.

Mr Haji-Ioannou's model, by contrast, milks the demand curve for every penny he can get. He can pocket the extra that the impatient and spendthrift are willing to pay to have just what they want when they want it.

The other leg of his strategy is ruthlessness with costs. Extras, such as meals, flexibility or convenience are stripped out. People pay for the basic service and nothing more. EasyCinema customers, for example, have no tickets: they print out a bar-coded entry pass from their computer. As with his other businesses, all booking is online. EasyCar offers one kind of car at each location; these are spartan outfits—one-person huts in the corner of a car park. Customers must bring their car back within a one-hour slot, clean and ready for the next user, or pay a penalty. EasyJet offers short-haul flights only, from minor airports, with no food or drink. Service, in short, is as commoditised as possible.

That allows gimmicky low-cost offerings. The 20p starting price for his cinema was a one-off, but Mr Haji-Ioannou reckons that he breaks even if he sells half the seats in each screening for £1.50-2.00 ($2.45-3.30)—about a third of what other cinemas charge.

The biggest effect of this approach is not on his own customers, but on those of the many competing companies that have cut prices and empowered customers as a result. Online booking at British Airways, for example, now gives the customer a lot more choice about time and price. His internet cafés have driven down prices sharply.

It would be nice to report that, with its sound grounding in economics, everything in the easy empire was going swimmingly. But as the likeable Mr Haji-Ioannou himself cheerfully admits, this would be a bit of a

stretch. “My record is patchy at best,” he says. “I have had a couple of successes, a couple of failures—the jury is still out on everything else.”

The verdict so far is indeed mixed. The first and most successful business in the group is easyJet, set up in Luton in 1995 with the help of money from his father, a shipping magnate. Though the airline made a loss in the first half of this year, it is likely to make a profit for the year as a whole, despite the horrors faced by other airlines. EasyJet's capacity was hugely increased by its purchase last year of Go, which used to be British Airways' low-cost airline until BA sold it to a venture-capital group.

His other ventures have been less fruitful, in part, says Mr Haji-Ioannou, because he took his eye off the ball. The internet cafés have lost up to £90m, by his estimation. The sites (one in New York was the world's largest) were too expensive. So were the computers. Rather than put the business into bankruptcy—which would have done little for his reputation—he has cut costs and branched out. Easy's computer terminals are now being installed in other locations, such as Burger King restaurants.

The car company has certainly cut prices for consumers. The business is in better shape than the cafés and may break even next year. But it has been hit by the congestion charge in London, home to 3,000 of its 8,500 fleet. And it is finding it hard to dent the big rental firms' business.

For the moment, however, Mr Haji-Ioannou's mind is on the cinema. After the opening he was scooping up the rubbish to see what food products people had brought with them. But although some 6,000 people have booked to see films at his cinema, he will not open another one yet. The six main distributors who control 90% of the films shown in Britain prefer to keep seats empty rather than flog them cheaply; they dislike easyCinema's cut-price offerings. The result is that, for now at least, his cinema can only show second-rate or second-run films. Until he cracks this cartel, Mr Haji-Ioannou's story, for all the admirable ideas behind it, will still be the stuff of an interesting documentary film rather than the box-office blockbuster it could be.

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Classical music

Allegro con brio

May 29th 2003
From The Economist print edition

Classical music is booming, contrary to the pessimism of most in the business

DULL, elitist and expensive, classical music in Britain is in its death-throes, the pundits say. The young prefer Boyzone to Beethoven. Punters shun the plinkety-plonk modern stuff, and stick to the same tired old repertoire, stifling innovation. Recording work has slumped, partly because of the CD's relative indestructibility, partly because orchestras in central Europe are cheaper. Corporate sponsorship, particularly from the City, has slowed sharply.

A true *largo doloroso*, then—were it not for the awkward fact that in the things that matter most, classical music is actually healthier than for decades.

For a start, London is more than ever the uncontested classical capital of the world, with some 20 professional orchestras and five music colleges. Many of the world's great soloists choose to make their home there, as do home-grown musicians in great quantity and quality.

In 1985, for example, the Association of British Orchestras had just 12 members; now it has 50. Up to half of this growth has come from new orchestras, says Russell Jones, its director, such as the Orchestra of the Age of Enlightenment—an outfit that specialises in music from that eponymous 18th-century era.

For all the much-bewailed changes in state subsidy policy towards more popular causes, plenty still flows. The Arts Council recently rescued several ailing bands with money from the National Lottery. Over the past three years it has pumped £30m ($49m) into orchestras to get rid of their deficits. Strings were attached: orchestras had to produce detailed future plans. Mostly these seem to be working; a handful is even making surpluses, says Hilary Boulding, the music director for the Arts Council of England.

In the great cacophony of government spending, £30m is a mere tinkle. Yet its effect is far-reaching, because necessity has made Britain's orchestras and musicians astonishingly flexible. Until recent years many of those who went to Britain's ten music colleges expected to make a living performing. Now even those with a relatively secure orchestral job realise they have to teach, too. Such work is usually a condition for getting money from the state.

The London Symphony Orchestra (LSO), for example, is spending £18m on an education programme based in St Luke's, a disused inner-city church. Clive Gillinson, the LSO's respected manager, claims that its programme reaches 30,000 children. Almost all orchestras now play to and teach some locals; Manchester's Hallé has set up its own youth orchestra.

That partly explains why, despite all the handwringing, and the lack of music-making at state schools, there is no evidence that audiences are ageing. Instead, people still seem to warm to classical music as they age, much as they always have.

The CD market is also showing hopeful signs. Orchestras are finding new ways to entice people to buy fresh versions of works they already own. One is to play bygone music on bygone instruments (or copies). Trumpet players these days are likely to finish music college able to play both the modern instrument and the (valve-less) natural trumpet, for which Baroque trumpet parts were written. Another is orchestras' own-label recordings of live performances. That cuts the cost of recording studios, and fees too—players, soloists and conductors all get a slice of the royalties. The Royal Liverpool Philharmonic started this trend, with a recording business run by the principal oboeist.

Sponsorship is more difficult to come by, especially now that the economy is weak, but far from impossible. There is still money for those that “tick the social responsibility box”, says Mr Jones. Much of

the £16.5m that the LSO has already raised for its St Luke's project has come from companies.

The purists' best-grounded lament is that top-selling classical CDs are such an unchallenging lot, chiefly film music “Harry Potter”, “Lord of the Rings”, trite compilations (Classical Chillout Gold), and cheesy tenors and the products of eye-catching artistes. But if people like the ear candy, they may develop a taste for better fare thereafter.

What would really change things would be more listenable modern music. That may be happening, thanks to composers like John Taverner or Thomas Adès. Jeremy Summerly, a musicologist, says that the “new complexity” of the 1960s has given way to “new simplicity”. Few went to premières when he was a student, he notes. Now, by contrast, “even normal people go”.

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Celebrity exports

Stark start

May 29th 2003
From The Economist print edition

British pop stars on the world stage

NOBODY expected a crown of laurels, but this was unbearable. Jemini, a Liverpool pop duo dispatched to Latvia to represent Britain at the Eurovision Song Contest—the music world's answer to Miss Universe—crashed to ignominious defeat on May 24th after failing to secure a single vote out of 260 cast. It was the nation's worst showing ever in the competition.

Explanations for the catastrophe appeared almost immediately. Some put it down to other Europeans' post-Iraq pique; others pointed, chests a-thumping, to the big picture (what language were most songs written in? English!).

But the brave words ignore a broader trend: Britain's growing trade deficit in superstars. The nation's top celebrity couple is now trying to turn things around. David and Victoria Beckham have embarked on a global self-marketing blitz, starting in America. Mr Beckham is already world-famous—the footballer shook hands with Nelson Mandela last week, and it is difficult to know whose grandchildren will boast most of the encounter. But football-ambivalent America will be a hard sell.

His other half is faring even worse. The *New York Times* remarked coldly: “it isn't clear what Ms Beckham, 29, has to offer”. America has plenty of modestly talented nubile starlets already. The former “Posh” Spice girl is known chiefly for her role in a pop group that was, until recently, thought to be one of the worst Britain has ever produced. Even her husband's dazzling skills cannot outweigh that.

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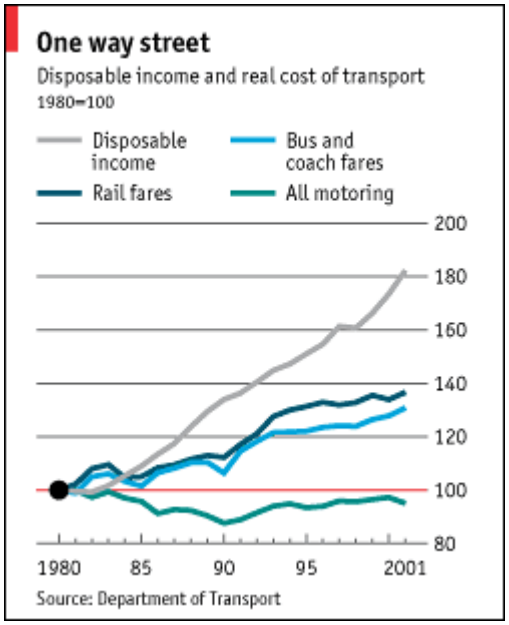
Rail

Rail wail

May 29th 2003
From The Economist print edition

Raising rail fares will not solve the network's problems.

Get article background



IN THE old days of nationalised railways, whenever passenger growth exceeded the capacity, the automatic response was not to boost capacity, but to raise fares. History is about to repeat itself. Sharp increases in fares are to be announced by the transport secretary, Alistair Darling, in the next few days. Inter-city fares will be totally de-regulated while commuter fares are likely to rise by at least 4%.

Choking off demand for rail travel is directly contrary to the aims of the government's ten-year transport plan. It will make car travel even more attractive (see chart) and inevitably increase congestion.

The fares hike follows a review by the Strategic Rail Authority (SRA) which concluded that the current policy of reducing fares by 1% each year in real terms was unsustainable. Mr Darling has accepted that, but rejected the SRA's proposal that commuter passengers in the south-east should bear the brunt with a 10% increase.

Such a big rise, more than four times the inflation rate, would have provoked a huge passenger revolt. Even so, Mr Darling is under no illusion about the unpopularity of the much reduced across-the-network rise that he is about to announce. He is likely to sweeten the pill by linking the increase to improvements in performance. But this will be hard to achieve at a time when the debt-ridden railways are struggling and more than a fifth of trains are arriving late. Only better service would make customers accept higher fares.

The SRA's case for a big increase is that money is urgently needed for investment. Fare revenues cover barely half the £9 billion cost of running the network; the rest has to come from the taxpayer. Network Rail, whose debt ballooned to over £10 billion in results published this week, says it needs £1 billion more than that over the next three years, simply to keep the network running. One place to look for savings would be the lightly used branchlines easily replaceable by buses. These lines currently soak up over £1 billion in subsidy each year, despite earning less than a fifth of the network's overall revenue.

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Speed cameras

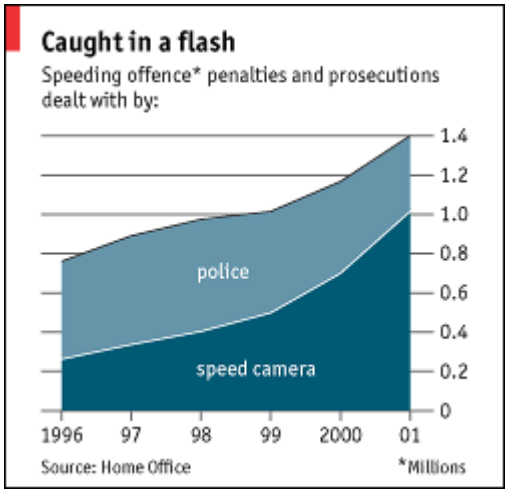
Boxing clever

May 29th 2003
From The Economist print edition

Speed cameras work well but the authorities are too timid to use them

FEW things could do more to fuel the national paranoia about speed cameras than this week's furore, about an ambulanceman facing prosecution for driving at 104mph while rushing to deliver a liver for an emergency transplant operation. No matter that the case seems to be a bizarre mistake by the authorities, stemming from an oddity in the law: even law-abiding people see lethal speed as a right, and attempts to control it as an outrage. Even more oddly, the police seem to agree.

At first glance, though, speed cameras are working. In eight trial areas over the past two years, they reduced deaths and serious injuries by more than a third. Nearly 2m drivers, one in every ten, are likely to be fined for speeding this year, three-quarters of them caught on camera. The government's decision to allow police forces to recoup the cost of enforcement through fines has led to a huge increase in penalties (see chart).



But the real story is that enforcement is extremely patchy. In 30mph urban areas, only two of the 43 police forces in England and Wales (Cleveland and North Wales) comply with the 35mph threshold recommended by the Association of Chief Police Officers (ACPO). In London, the cameras are set to flash at a speedy 43mph in order, amazingly, to reduce the work load of issuing fixed-penalty notices.

Given public habits, it is easy to see that enforcing the law would be a lot of work, at least at first. Two-thirds of cars routinely exceed the 30mph limit while more than half exceed 70mph on motorways. But that seems no reason for holding back. The half-hearted approach is reflected in other oddities—such as the government diktat that speed cameras must be painted bright yellow, and accompanied by conspicuous road markings. There is little rational explanation for this.

The minister of transport, John Spellar, has chosen to ignore his own department's research showing, unsurprisingly, that hidden cameras work best. Although the bright yellow boxes do help law-abiding drivers keep to the limit, law-breakers manipulate the system by braking when they see a camera. Undermining drivers' confidence in their ability to spot cameras, the study concluded, would reduce speed-related accidents. These not only kill and maim hundreds of people every year, but deter cyclists and pedestrians, especially children, from exercising their right to the road. Speed cameras have already worked well. They should be allowed to do an even better job, for all the car lobby's tiresome tantrums.

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Blood disposal

Bleeding them dry

May 29th 2003 | WIGAN
From The Economist print edition

Squeamishness and bureaucracy are a bloody nuisance

SLAUGHTERHOUSES don't come much nicer than John Chadwick's. Clean and smartly designed, with walls and disinfecting tanks in brushed steel, the small red-meat facility in Wigan is regarded by others in the animal-killing business with something approaching awe. “It's too good for a slaughterhouse—it's more like a palace,” says Brian George, a South Wales abattoir owner. According to carefully cultivated legend, a local hygiene inspector once said that he would rather go there for an operation than any nearby hospital.

But new European regulations on animal waste may force the closure of this model meatpacker. The problem centres on the “sticking” (ie, throat-cutting) part of the slaughtering process. At present, the blood from about five cattle and 40 lambs a week goes into the sewer system. This method of disposal, used by about a third of slaughterhouses, is out of favour in light of health scares and general public queasiness. In future, all waste blood must be incinerated.

In Mr Chadwick's case, the offensive liquid will have to be carted away, probably to Prosper De Mulder, a Doncaster-based outfit that dominates the British animal-waste market. This company is likely to handle most of the extra 150,000 tonnes of waste blood resulting from the new rules. The government reckons that disposal costs will rise from £16 to £60-80 a tonne. Distant regions may well pay even more.

The new regulations pose little threat to large slaughterhouses, which produce blood in such volume that it is worth selling on to fertiliser companies or pet-food manufacturers. So some consolidation is likely. The cost will be paid by the consumer, by farmers, and by the animals themselves, especially if they are trucked over longer distances to the surviving slaughterhouses.

And it may make it more difficult to track the spread of disease. Mr Chadwick's slaughterhouse, like some other small ones, is a complete meat-processing facility—cows go in one end, steak and sausages come out the other. If customers get ill, it is easy to work out why.

The scientific case for the new rules is fuzzy. The government's BSE advisory committee looked into blood-disposal methods in 1996, at the height of the public health panic, and saw no problem in sending surplus corpuscles down the drain. Using raw blood as a fertiliser or burying it in the ground—two other means of getting rid of it—may strike some as distasteful, but are not actually dangerous.

So what lies behind the new regulations? John Strak, of the *Whole Hog*, a pig farming journal, points to post-disaster paranoia. “When it comes to food, nobody wants to talk about risk analysis. Banning things is much simpler.”

The slaughtermen are less charitable. They say the authorities want to close small facilities, which are expensive to inspect; they also believe that other countries are too corrupt or disorganised to enforce the regulations. Many, like Mr Chadwick, are dragging their feet, hoping for a change of plan. This has worked in the past—most recently with new rules banning the burying of dead farm animals, which farmers said were too complex and costly. But it is an odd way to run the food industry.

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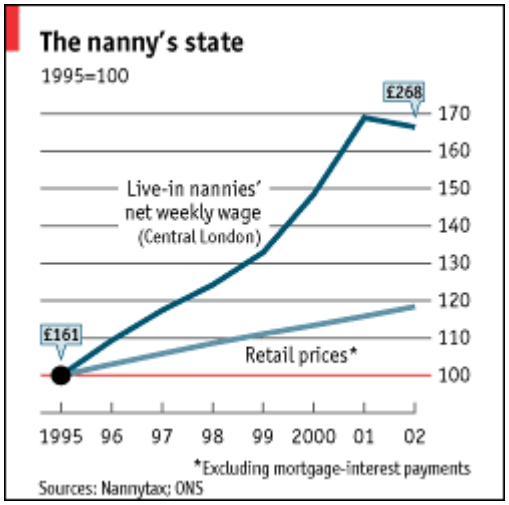
Child care

Nanny deflation

May 29th 2003
From The Economist print edition

Posh tots have a bit more bang for their bikkie



NANNIES' wages in London have long outstripped inflation. This year is different. Nannytax, a payroll company that deals with 6,000 households, recorded a drop in the rate of pay for live-in nannies in Central London for the first time since its survey began seven years ago (see chart). Live-in nanny wages for the country as a whole registered a small increase of 3%, to £208 net per week, a dramatic slowdown on 2000-01, when wages rose 17.5%.

Lay-offs in the City and elsewhere mean that fewer parents can afford the luxury of top-flight full-time child care. Patricia Tarran of Buttons Nanny Agency says that many of her nannies were made redundant last year, typically after the children's father lost his job.

Parents are now resorting to what Stephen Vahrman of Nannytax refers to as “pick and mix” child care. They will employ a nanny part-time, say before and after school, and during school holidays, or share a nanny with neighbours rather than have her all to themselves. Perks like a car, mobile phone, or health club membership are no longer part of the package. Parents expect more too—even a spot of cleaning while the children are at school. The recent 1% increase in employers' national insurance contributions also tightens the squeeze. A live-in nanny will now cost her employers £18,000 gross per year.

Hard-pressed parents will be glad if the cost of nannies moderates further. But what they would really like is to be able to deduct the cost from their pre-tax income. The government has given a modest tax break for child care at home—but only for households earning less than £43,000. That is a tiny proportion of the traditional nanny-employing classes.

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Bagehot

A New Labour nightmare

May 29th 2003
From The Economist print edition

Fear of the press has put Tony Blair on the wrong side of the referendum argument

ON THE morning of the 1992 general election, the front page of the *Sun* carried a picture depicting the head of the Labour Party leader inside a light bulb next to the headline: “If Kinnock wins today will the last person to leave Britain please turn out the lights”. For anyone who is puzzled why the government is so doggedly resolved not to allow a referendum on the new European constitution, the reason is right there.

The psyche of New Labour was formed during Neil Kinnock's decade of vilification. He may have lacked some of the qualities needed to make a successful prime minister, but the Tory tabloids ensured that he never stood a chance. New Labour's control freakery and obsession with spin was a direct result of the determination of the likes of Peter Mandelson and Alastair Campbell, who had witnessed from the inside Mr Kinnock's destruction, not to allow the same thing to happen to Tony Blair.

To that end, Mr Blair was also packaged and sold directly to the owners of the most powerful right-wing newspapers both as a winner and as the true heir to Margaret Thatcher's legacy. Before becoming prime minister, Mr Blair supped frequently with the late Lord Rothermere, the proprietor of the *Daily Mail*. Once he even flew to Australia at the invitation of Rupert Murdoch, the proprietor of the *Sun*, to make a speech on leadership to the tycoon's top executives. It worked, but deep down, New Labour has never lost its fear and loathing of the press.

With two landslide election victories under its belt and a Conservative Party that still shows few signs of revival (under a leader who is himself on the receiving end of some Kinnock-style mockery), you might have thought that a powerful government would be more confident of its ability to shape the political agenda. You would be wrong.

There are times when the home secretary, David Blunkett, appears to be taking his orders almost directly from the editorial page of the *Daily Mail*. The government lives in a constant state of anxiety about the ability of the Tory newspapers (though not the Tory party) to belittle and undermine what it sees as the progress it is making in improving public services. On the other hand, with most of the same newspapers cheering him on, Mr Blair felt strong enough to confront his party over Iraq.

Which brings us back to Europe. Thanks to Mr Blair's commitment to hold a referendum before joining the single currency, there has been a kind of armed truce between the government and the anti-European press. Each has known that they might one day come to blows over the euro. But as long as Gordon Brown was Keeper of the Five Tests, it has seemed a fairly distant prospect, even as the chancellor's verdict, to be delivered on June 9th, draws near.

However, this informal non-aggression pact has had two important consequences. The first is that it probably lulled the government into thinking that some of the heat had gone out of Europe as an issue, particularly as even the Tories no longer seemed very keen to talk about it. The second is that it convinced Mr Blair that he must do everything to avoid his European policy being again exposed to the loose cannon of referendum politics.

Once a referendum was conceded on anything to do with Europe, Mr Blair reasoned, the Europhobic press could be relied on to poison the argument so thoroughly that even the most moderately integrationist proposal would stand little chance of gaining support. Promising a vote on the euro was a mistake not to be repeated. It followed that if Britain was to play a positive role in designing a new constitution for the European Union the best thing was to pretend that nothing very important was going on in Brussels. The national interest was therefore perfectly safe in ministerial hands.

Given the kind of coverage that the latest draft of the constitution has been getting this week—“Death knell for democracy”, screamed the *Daily Mail*; “The end of our nation”, bellowed the *Sun*— it was entirely understandable, if naive, that Mr Blair should have hoped that this ruse might work. Even without this level of hysteria, it would still be clear to most people who can be bothered to look at the thing that the government is being economical with the truth in describing the constitution as a mere “tidying up” of existing treaties. And having enthusiastically conjured up referendums to decide on everything from Scottish and Welsh devolution to whether or not Hartlepool would like to be run by a mayor, to many it also seems a bit rich now to be talking sonorously about upholding the principles of parliamentary democracy.

Trust me, I'm a politician

The government's hope is that the newspapers have fired their heavy ordnance too early—it could be at least nine months before the final version of the constitution emerges from the inter-governmental haggling which will come next—and that their readers will get fed up with the unrelenting bombardment. Certainly, the *Daily Mail's* idea of holding its own referendum on June 12th looks premature. The government is also counting a great deal on the public's trust in Mr Blair, who will soon bring the full force of his persuasive powers to the debate.

But, unfortunately from the prime minister's point of view, that debate will now be more about his refusal to permit a referendum than about the kind of future Britons want in Europe. Frank Field, an independent-minded Labour MP, who has helpfully drawn up a referendum bill, observes that we live in a non-deferential age in which patients question their doctors, teachers have to win respect and the authority of the police is challenged. Regardless of those horrid newspapers, Mr Blair will have his work cut out convincing people that they should not be consulted over the way they are governed.

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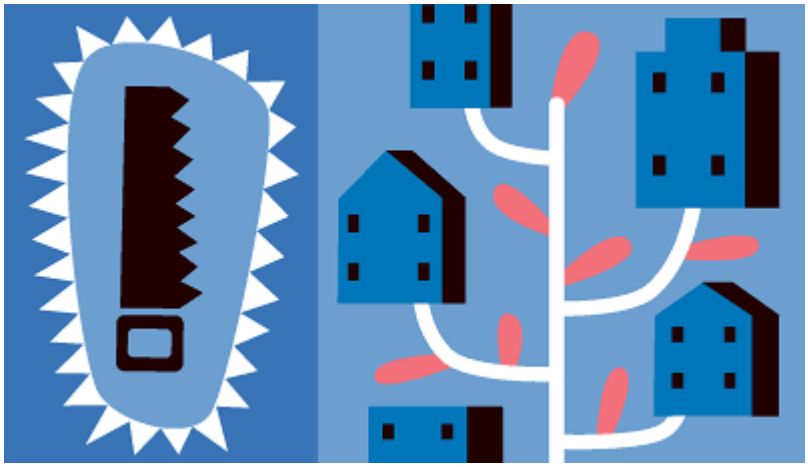
House of cards

May 29th 2003
From The Economist print edition



In many countries the stockmarket bubble has been replaced by a property-price bubble. Sooner or later it will burst, says Pam Woodall, our economics editor

“BUYING property is by far the safest investment you can make. House prices will never fall like share prices.” This is the advice offered by countless estate agents around the globe. In the absence of attractive investment opportunities elsewhere, home buyers have needed little encouragement: from London to Madrid and from Washington to Sydney, rising house prices have been the hot topic of conversation at dinner parties. Over the past seven years, house prices in many countries have risen at their fastest rate ever in real terms. And now institutional investors are also eagerly shifting money from equities into commercial property. Many property analysts scoff at the suggestion that another bubble is in the making. House prices may have fallen after previous booms, but “this time is different”, they insist. That is precisely what equity analysts said when share prices soared in the late 1990s. They were proved wrong. Will the property experts suffer the same fate?

This survey will examine investors' current love affair with both residential and commercial property (or real estate, as Americans call it). It will explore the latest trends in property prices around the globe and consider different methods of estimating fair value in order to assess whether there is a bubble. This may well be the single most important question currently hanging over the world economy. Given the fragile state of many economies, the bursting of a housing bubble could easily drag them into recession.

Property is probably the biggest business in the world. By one estimate, construction, the buying, selling and renting of properties and the imputed benefits to owner-occupiers account for around 15% of rich countries'GDP. Property also makes up around two-thirds of the tangible capital stock in most economies. Most important of all, property is by far the world's biggest single asset class. Investors have much more money tied up in property than in shares or bonds (see chart 1).

A lot more people own homes than own shares. In all the big developed economies bar Germany, well over half of all households are home-owners (see chart 2). In most of Europe and Australia, housing accounts for 40-60% of total household wealth, and in America for about 30%. And even in America the typical household on an average income holds six times as much wealth in residential property as in shares.

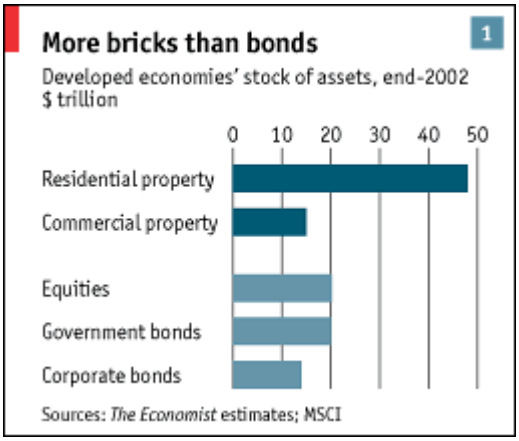
Yet, curiously, there has been much less economic research into the property market than into the stockmarket, the bond market or the foreign-exchange market. One reason is that until recently much of this property investment was held fairly passively. For most people a home was simply a place to live. For most firms offices were a necessary but relatively unimportant part of their infrastructure. Commercial property made up less than 5% of most institutional investors' portfolios. But now many

people, having lost faith in shares, see their home as an investment that will appreciate rapidly in value. Financial institutions are also pushing up the share of commercial property in their portfolios. To both sorts of investor, property seems to offer attractively high returns—as well as a safe haven in an increasingly risky world.

Betting the house

Over the past few years, house prices have been booming almost everywhere except Germany and Japan. Since the mid-1990s, house prices in Australia, Britain, Ireland, the Netherlands, Spain and Sweden have all risen by more than 50% in real terms. American house prices are up a more modest 30%, but that is still the biggest real gain over any such period in recorded history. Commercial-property prices in some big cities have also been looking rather frothy.

These property booms have been partly driven by economic fundamentals, but bubble-like symptoms abound. Real-estate investment has even made it into a TV series, “The Sopranos”. In one recent episode, the wife of Tony, the Mafia boss, suggested he invest in a real-estate investment trust (a fund which enables small investors to buy commercial property). Many viewers took her advice.



Rewards from investing in property in the past are certainly impressive. In Britain, for example, over the past ten years the total return from both commercial and residential property (including rental income) has been well over 10%, beating the return on equities or gilts. Over the past three years, British house prices have risen by 55%, whereas share prices are 40% down.

Over the past ten years, the total return from buying a house (including the implicit rental income) has exceeded the return from shares in half the countries in chart 3. But these figures understate the possible gains from investing in property. Unlike equities, most homes are bought with borrowed money, and the resulting leverage can greatly lift the return on the initial stake (or increase any loss). Suppose you had invested $20,000 in shares, which after five years are now worth $40,000, including reinvested dividends, implying an annual return of 15%. Then suppose you had used the $20,000 as a deposit on a $100,000 house that over five years had risen in value by a more modest 7% a year, to $140,000. Assume, for simplicity, that mortgage-interest payments and maintenance costs exactly offset the rental income. The average annual return on your deposit would have been almost 25%.

In addition, the taxman tends to treat housing far more favourably than financial assets. In most countries, owner-occupiers get tax relief on their mortgage interest payments or first-time buyers get a tax credit, and owner-occupiers are at least partially exempt from capital-gains tax. Admittedly the transaction costs of buying and selling property are high, but on reasonable assumptions the after-tax return from housing over the past decade has exceeded that from shares in most countries.

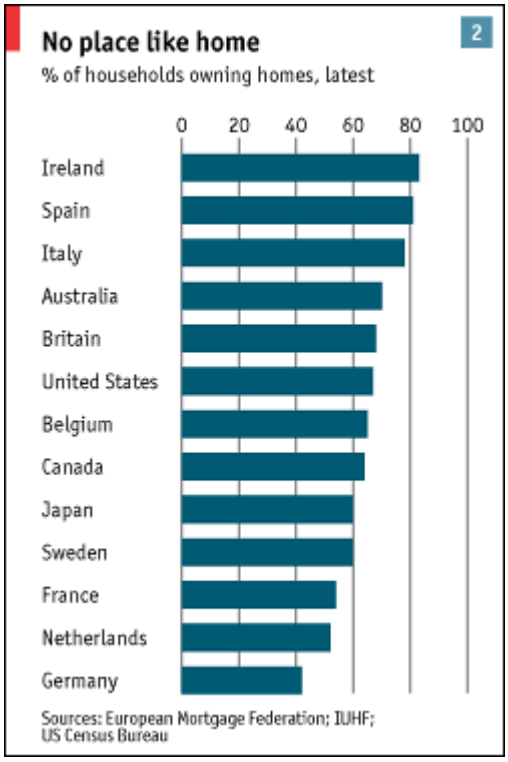
How long can the party last? Estate agents, builders, lenders, many economists and even Alan Greenspan, chairman of America's Federal Reserve, have all insisted that there is no house-price bubble. Rising house prices, the argument goes, are fully justified by low interest rates, rising real incomes, growing populations and a fixed supply of land. But this sounds a little like the “wall of money” argument used to defend inflated share prices in the late 1990s. Prices had to rise, it was said, because the number of shares in which pension funds could invest their billions was limited. Investors mistakenly came to believe that the traditional link between share prices and profits no longer mattered. Home-owners may be making a similar mistake today.

It is often argued that property is a much safer investment than shares because a share is just a (possibly worthless) piece of paper, whereas bricks and mortar are something tangible. Yet that tells us nothing about their relative value. Bubbles form when the price of any asset gets out of line with its underlying value.

Home prices are not listed daily in the *Financial Times*, but the same sort of valuation analysis can be applied to houses as to

shares. The price you pay for a property should reflect the future rent at which you could let it. The fact that in many countries prices of homes and commercial buildings have been rising much faster than rents should be ringing alarm bells.

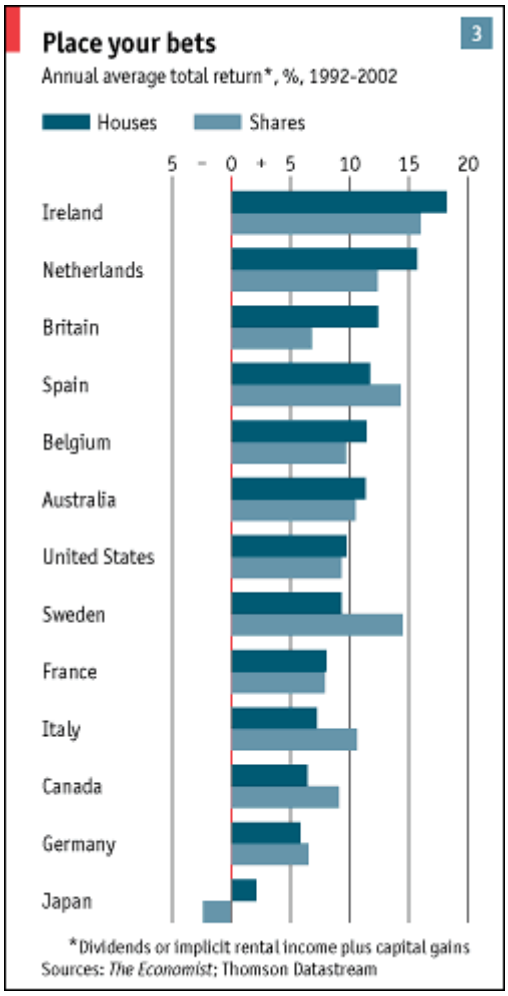
Housing is just as prone to irrational exuberance as is the stockmarket. Property is increasingly viewed as an easy way to make money. People buy a home in the expectation that its price will continue to rise strongly over time. Such expectations lie at the heart of all bubbles. Given the boom in the property market over the past few years, at the very least house-buyers betting on further rapid house-price gains are likely to be disappointed. Worse, there is a risk that house prices will take such a tumble that they take whole economies with them.



Vicious cycles

Swings in property prices can have a big impact on economic growth. Since the IT and stockmarket bubbles burst, rising property prices around the globe have helped to prop up the world economy. Rising house prices have boosted consumer spending by making people feel wealthier, offsetting the effect of falling share prices. Consumers have also been able to borrow more against the higher value of their homes, turning capital gains into cash which they can spend on a new car or a holiday. For firms, property is the main form of collateral for borrowing, so swings in commercial-property prices can also influence corporate investment.

But just as rising house prices help to boost spending, so falling house prices can cause economic pain. In an analysis of a number of earlier housing bubbles, the IMF's latest *World Economic Outlook* found that output losses after house-price busts in rich countries have on average been twice as large as those after stockmarket crashes. The average real decline after a house-price bust has been more modest than after a stockmarket crash (30% over four years against 45% over two-and-and-half years), but at the end of that period GDP had fallen by an average of 8% relative to its previous growth trend, compared with 4% after a share-price bust. The IMF also found that a sharp rise in house prices in real terms is much more likely to be followed by a bust than is a share-price boom.



There are three reasons why a house-price bubble might cause more harm on bursting than a stockmarket bubble. First, house prices have a bigger wealth effect on consumer spending, largely because more people own their homes than own shares. A study of 14 countries by three American economists, Karl Case, John Quigley and Robert Shiller, found that in most economies a change in property prices had at least twice as big an effect on consumer spending as a change in share prices of the same order.

Second, people are much more likely to borrow to buy a home than to buy shares. Some of them inevitably borrow too much and later have to curb their spending. Third, a decline in property prices also leaves some households with homes worth less than the amount they have borrowed, so housing busts have a greater effect on banks, which are typically heavily exposed to real estate. Falling house prices lead to an increase in banks' non-performing loans, and as their collateral shrinks, so does their capacity to lend.

This survey will conclude that the latest housing boom has inflated bubbles in several countries, notably America, Australia, Britain, Ireland, the Netherlands and Spain. Within the next year or so those bubbles

are likely to burst, leading to falls in average real house prices of 15-20% in America and 30% or more elsewhere over the next few years, in line with average price declines during past housing-market busts. This time, however, with inflation so low, house prices will fall more sharply in money terms than they did in the past. In Britain as a whole, for example, average nominal house prices are likely to drop by 20-25%, and in London by much more. Significant numbers of owners may be left with homes worth less than their mortgages—especially as the proportion of owner-occupiers with mortgages exceeding 80% of the value of their homes is higher now than it was in the previous bust in the early 1990s.

There are already signs in some cities, such as London, New York and Amsterdam, that the housing market is cooling fast, but estate agents still insist that prices are unlikely to fall by much. Tell that to the couple who bought a four-bedroom house in San Francisco for $2.1m in 2000, then divorced and had to sell the house only two years later for $1.45m.

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A boom out of step

May 29th 2003
From The Economist print edition

The recent surge in many countries' house prices has been oddly timed

MOVEMENTS in house prices have a much bigger effect on economies than swings in share prices. Unfortunately timely data on house prices across different countries are much harder to come by than share-price information. To help fill this gap, *The Economist* last year launched a set of global house-price indices for 13 developed economies, going back to 1975 and giving both nationwide averages and figures for big cities. The data, which are updated quarterly, come from a variety of sources, including estate agents, lending institutions and government agencies. The indices may not be fully comparable between countries, but they are based on the most reliable figures available.

Since 1995, house prices have increased threefold in Ireland, more than doubled in the Netherlands and Britain, and gained at least two-thirds in Australia, Spain and Sweden (see table 4). After adjusting for inflation, real house prices have increased by more than 25% everywhere except Japan, Germany, Canada and Italy. In many countries prices have risen faster in real terms than during previous booms.

What has been unusual about this boom is the timing. Real house prices normally fall during economic downturns, but in this cycle prices in most countries have accelerated. Low inflation has meant that central banks have been able to slash interest rates. This has encouraged new mortgage borrowing, fuelling house-price inflation. The biggest increases in house prices last year were in Britain (25%) and Australia (18%).

The 27% real price increase in American homes since 1995 seems modest compared with the gains in some European countries, yet it is the biggest ever seen in the United States during any cycle in the past half-century, and twice as large as the price gains during the real-estate booms in the late 1970s or the late 1980s. National figures conceal even larger increases in some of the big cities. In New York real home prices have risen by 47% since 1995, almost twice as fast as the national average; in San Francisco they have jumped by 70%. In many other countries, too, prices in the big cities have gone up much faster than average, most notably in London, where prices have risen by a vertiginous 136% in real terms since 1995.

4 *The Economist* house-price indices

Nationwide average, % change

	1995-2002		2002*	
	Nominal	Real†	Nominal	Real†
Ireland	219	152	11.1	6.0
Britain	125	89	24.9	21.8
Netherlands	121	83	4.5	1.4
Spain	95	58	17.4	13.0
Sweden	68	56	9.2	6.9
Australia	83	53	18.4	15.0
Belgium	57	39	6.9	5.6
France	45	31	9.3	6.9
US	51	27	6.9	4.6
Euro area	35	19	5.7	3.4
Italy	29	8	10.0	7.1
Canada	18	2	6.7	2.8
Germany	-5	-13	-3.3	-4.4
Japan	-20	-19	-4.7	-4.2
Global index	35	18	6.1	4.2

City average, % change

	1995-2002		2002*	
	Nominal	Real†	Nominal	Real†
Dublin	273	195	12.1	7.0
London	182	136	21.4	18.4
Stockholm	115	99	8.8	6.6
Sydney	101	68	22.4	18.8
Amsterdam	102	68	1.1	-1.8
Madrid	101	63	25.4	20.6
New York	75	47	11.2	8.8
Brussels	50	32	16.0	14.6
Paris	37	23	10.2	7.9
Toronto	38	19	9.8	5.8
Milan	40	17	11.4	8.4
Frankfurt	9	-1	0.4	-0.8
Tokyo	-32	-32	-5.5	-5.0

*Year to Q4 †Adjusted for consumer-price inflation

Sources: Bulwien; ESRI; Japan Real Estate Institute; Ministerio de Fomento; Nationwide Building Society; Nomisma; OFHEO; Stadim; BIS; national statistics

At the other extreme, house prices have fallen in nominal as well as in real terms in Germany and Japan over the past seven years. A house in Tokyo now costs less than half what it did in 1991, after a now legendary property-price bubble in the late 1980s. Yet the 36% real increase in average house prices in Japan in the seven years to 1991 was less than the increase over the past seven years in half of the countries we track in our index.

German houses used to be the most expensive in Europe: in 1975, they cost three times as much as French ones. Today the two have more or less evened up, largely because German house prices have been steadily declining in real terms. Germany is still suffering a hangover from a massive construction boom after unification, encouraged by government subsidies and tax breaks. Prices in eastern Germany

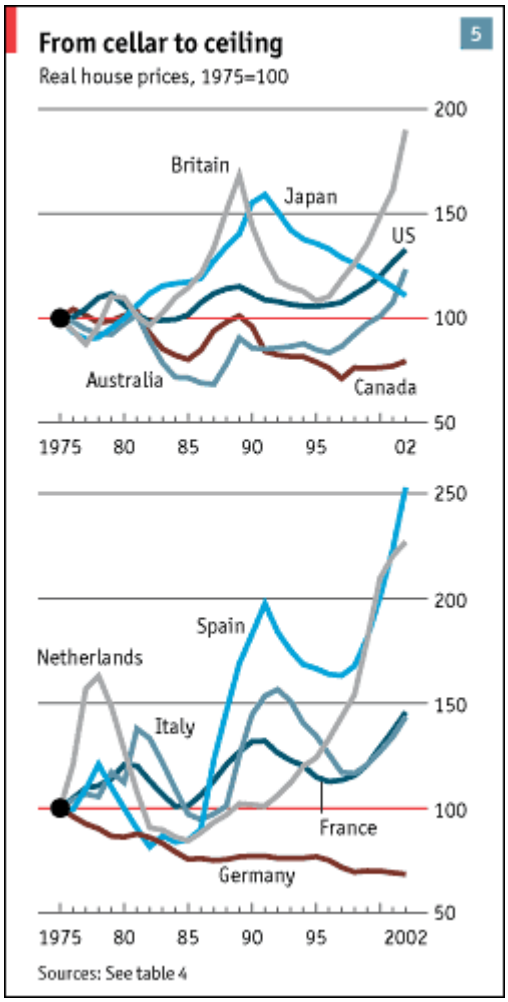
are still falling in response to excess supply, though in western Germany they have risen slightly over the past few years. It has not helped that Germany has the highest real interest rates in the euro area because it has the lowest inflation rate.

By contrast, in Spain, Ireland and the Netherlands, which have seen the biggest house-price gains in the euro zone, real interest rates in recent years have been much lower, or even negative, because these countries have had above-average inflation rates. Spain's housing boom has also been fuelled by rapid growth in jobs and incomes as the economy has been catching up with the rest of the European Union. Moreover, there was a frantic rush to spend black-economy pesetas and D-marks on homes in Spain before the introduction of the euro made them hard to convert. Some of the biggest price gains have been in holiday homes on the Costa del Sol and other coastal areas, thanks to a flood of foreign buyers, especially Britons and Germans.

Spain, Ireland and the Netherlands also have the most generous tax relief on home-buying in Europe. In the Netherlands, mortgage-interest payments are 100% tax-deductible at the buyer's top marginal rate. The Dutch mortgage market has also become much more competitive over the past decade, making it easier for home buyers to get bigger loans.

Ireland's extraordinary housing boom has been spurred by rapid population growth, negative real interest rates and a booming economy. The Irish government introduced anti-speculation measures in 1999-2000, including a 9% stamp duty on investment properties and an annual 2% tax on the value of a property for the first three years if rented out. These have since been abolished. After dipping briefly in 2001, house prices took off again last year.

The two other big euro-area economies, France and Italy, have both seen house-price inflation of 5-6% a year in real terms over the past four years, but this follows five or more years when real prices slumped after a boom in the late 1980s and early 1990s. Despite the recent jump in prices, Italian houses are still 8% cheaper in real terms than they were in 1992.



Surfing the waves

Over time, housing booms and busts in Europe, and especially in Britain, have been more pronounced than in the United States (see chart 5). House prices have also been more volatile in cities, where the supply of building land is more limited. For example, London house prices soared by 120% in the five years to 1989, then fell by 30% over the following four years. During the past five years they have leapt again, this time by 110%.

Over the past two decades national average house prices have rarely fallen by much in nominal terms (except in Britain and Sweden in the early 1990s, the Netherlands in the early 1980s and in Japan over the past decade). But in real terms, price declines of one-third or more are nothing unusual, examples being Australia, Italy and Spain in the early 1980s. Falls in nominal prices are much more common in big cities. Not only London but Boston, New York and San Francisco, too, saw prices drop steeply in the early 1990s.

After the boom of the past few years, the market now seems to be stumbling in some countries. House-price inflation has slowed sharply in America this year, and prices in New York have actually started to fall, especially at the top end of the market. Average house prices in the Netherlands dipped in the final months of last year. Prices in London have already fallen by 10% from their peak, and weakness is spreading to other parts of Britain. According to the Royal Institution of Chartered Surveyors (RICS), a net balance of 31% of surveyors throughout Britain said that prices had fallen in the three months to April. The cumulative fall in the RICS index over the past six months has been the largest since 1988, which heralded a steep fall in house prices. How far might prices fall this time?

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Location, location, location

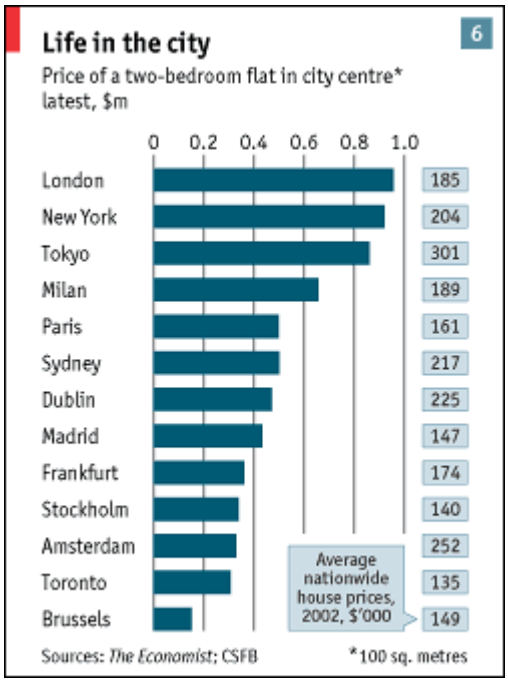
May 29th 2003
From The Economist print edition

The housing market has not heard of globalisation

THERE is a single global market for trading in bonds, shares and foreign exchange, but nothing of the sort for housing. Not only do house prices vary enormously across the globe, but so do the rules for buying and selling homes.

Chart 6 compares the price of a two-bedroom flat in a smart central area in 13 cities around the world. London is the most expensive, followed closely by New York and Tokyo: in all three such a flat costs more than $800,000. At the other extreme a similar apartment in Brussels can be bought for less than $200,000. Moreover, the typical two-bedroom flat in Manhattan ($925,000) can be rather gloomy and is unlikely to have a balcony. In contrast, $500,000 in Sydney will get you a light, spacious apartment, with a large balcony and waterfront view. Differences within Europe are also vast. Some Londoners are buying property in Paris, where that two-bedroom flat is half the price of the equivalent in London.

Average house prices in each country also vary widely. The average American home costs $204,000, not that much more than the average British home ($185,000), but it is two-thirds larger. Japan, despite a big fall in prices, still has the most expensive houses ($301,000).



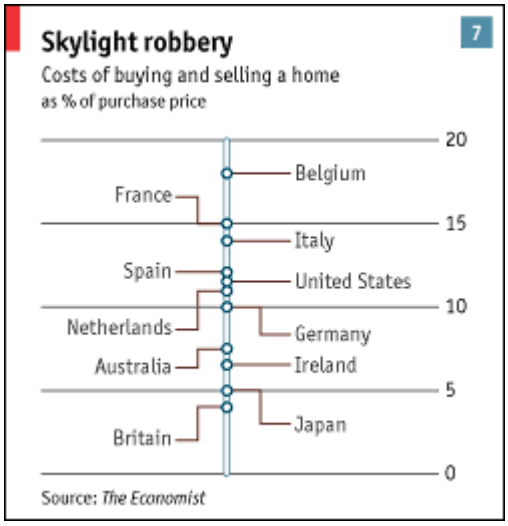
In most of continental Europe the combined costs of buying and selling a house amount to 10% or more of the purchase price (see chart 7), and in Belgium to as much as 18%. Even in America, transaction costs add up to at least 10%. In Britain, house buyers and sellers pay only 4-5% of the house price in stamp duty and estate agents' and lawyers' fees, but the emotional cost can be huge. Transactions on average take longer in Britain than in most other countries because a buyer can pull out at the last minute, and gazumping (where a vendor who has agreed to a sale accepts a higher offer from someone else) is common. This is because an offer is not legally binding until contracts have been exchanged, usually about two months after an offer has been accepted (except in Scotland, where a verbal agreement commits both sides).

At the other extreme is Australia, the only place in the world where most homes are sold by auction. Last year 70% of homes in Sydney went under the hammer. These auctions usually take place outside the house to be sold. The successful bidder has to put down a 10% deposit, and contracts are exchanged immediately. If a house does not reach its reserve price, the vendors may negotiate with the highest bidders afterwards.

John McGrath, the boss of McGrath Estate Agents, the largest privately owned agency in Australia, says the auction system works well in areas of dense population and strong competition, and would be suitable for New York or London too. Auctions are a good way to get markets to clear when demand is weak. But critics say that when competition is strong, the excitement created by an auction can push up the price, and the system may have been responsible for making Australia's bubble bigger.

However, in New York the highest bidder would not necessarily win the day. In Manhattan three-quarters of all apartments are co-ops, with shareholders rather than outright owners, where would-be

buyers must be approved by the co-op board. The interview can be a gruelling experience, as Madonna can testify: she once got turned down.



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Castles in hot air

May 29th 2003
From The Economist print edition

Is another bubble about to burst?

THE rapid house-price inflation in many countries over the past few years is clearly unsustainable. But will house prices just flatten off or will they slump? Alan Greenspan, who criticised the stockmarket's "irrational exuberance" long before that particular bubble was fully inflated, is more sanguine about American house prices. He accepts that there are local hot spots, but dismisses the idea of a national housing bubble that could harm the whole economy if it bursts.

In other countries where house prices have been rising, many analysts also pooh-pooh the idea of a bubble. They point out that interest rates are low, so people can afford to borrow more and are therefore willing to pay more for a home. The affordability index—mortgage-interest payments on an average-priced home divided by average income—is still quite low by historical standards in most countries.

There is something in this. First-time buyers who previously could not afford the typical mortgage payment can now get on the first rung of the property ladder. This pushes up effective demand and could possibly lift the equilibrium level of house prices. However, the cruder—and more widely used—argument that lower interest rates make homes cheaper to buy is badly flawed, because it ignores inflation. If interest rates are low only because inflation is low, then although initial mortgage payments are smaller, the real burden of mortgage debt will be eroded more slowly over time, and payments will remain high in relation to income for much longer. Lower inflation shifts the profile of payments over the life of a loan—you pay less in the early years and more (in real terms) later on—but the total real cost is the same. Home-buyers who think that low interest rates make buying a house cheaper are suffering money illusion. It is as foolish as thinking that a car loan paid off over five years is cheaper than one paid off over only two years.

Lower real interest rates, after allowing for inflation, would indeed reduce the true cost of buying a house. But in many countries real rates are not particularly low, and tax relief on mortgage payments also becomes less generous as nominal interest rates fall. Sabina Kalyan, an economist at Capital Economics, a London-based consultancy, calculates that real after-tax mortgage rates in Britain (where tax relief has been scrapped) are now much higher than they were in the 1960s and 1970s, and only marginally lower than in the 1980s and 1990s. And even in countries that still enjoy tax breaks, such as America, real after-tax mortgage interest rates have probably increased over time, because the size of the tax benefit shrinks with falling inflation. For instance, if interest rates are 10% and inflation 8%, and your marginal income-tax rate is 40%, then the real interest rate you pay is minus 2%. With 4% interest rates and 2% inflation (ie, the same pre-tax real interest rate), the real after-tax rate is plus 0.4%.

A second popular reason cited for a continued rise in house prices, especially in big cities such as London or New York, is the combination of a growing number of households and a limited supply of homes. Supply, it is argued, cannot keep up with demand because of a physical shortage of land, so prices will keep rising. This certainly helps to explain why house prices in big cities have tended to outpace those in rural areas, but it is not a reason to expect prices to keep rising indefinitely. Supply constraints are already factored into current prices; they will not necessarily stop prices declining in future. Just look at Hong Kong, where the supply of land is more strictly limited than in most cities. That has not prevented house prices falling by 65% over the past five years.

What's it worth?

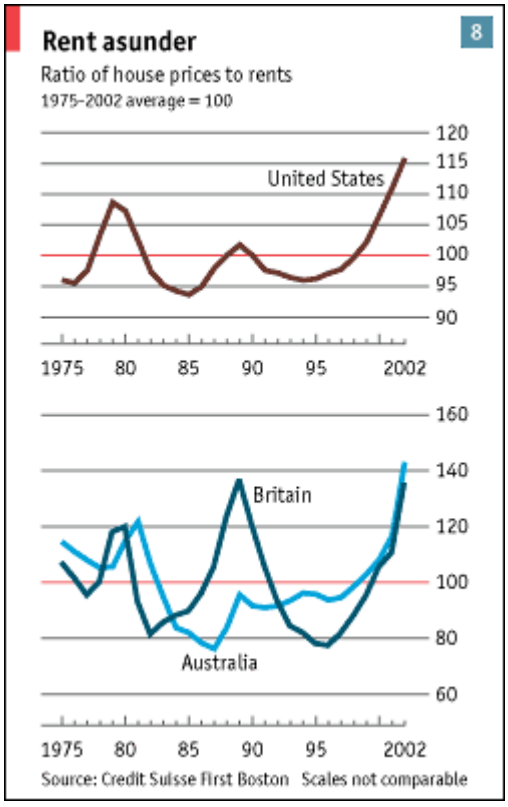
Neither low interest rates nor population growth can justify recent house-price booms. Moreover, the thinking behind both arguments reflects a lack of understanding about how asset prices are determined. On any given day, a house is worth whatever somebody is prepared to pay. However, the lesson from the stockmarket bubble is that an asset's fundamental value must never be neglected. There are two

ways to gauge whether house prices are sustainable: the p/e ratio and the house-price-to-income ratio.

• The p/e ratio. The price of any asset should reflect its future income stream. Just as the price of a share should equal the discounted present value of future dividends or profits, so the price of a house should reflect the future benefits of ownership—either the rental income earned by a landlord or the implicit rent saved by an owner-occupier. During the dotcom bubble, investors behaved as if profits no longer mattered. Likewise, people today are ignoring the link between house prices and rents.

In America, for example, a p/e ratio of sorts for housing can be calculated by dividing an index of average house prices by the index of rents which is included in the consumer-price index. In recent years, home prices in the United States have outpaced rents, pushing the p/e ratio to record levels, 16% above its 30-year average (see chart 8). San Francisco's p/e is almost 30% above trend. Estimates of p/e ratios for Britain, Australia and the Netherlands point to an even more pronounced bubble, suggesting that house prices in all three countries are at least 30% too high.

All this means that the return from investing in property has slumped. These p/e ratios are based on average rents, but over the past year or so rents on new lettings have fallen by 20-30% in New York, San Francisco and London. In London and Sydney gross rental yields (rents divided by price) have fallen to around 4%, from 7-8% a few years ago. In these cities it is now cheaper to rent than to buy.



The p/e ratio helps to expose the fallacy that house prices are rising because of growing populations and fixed supply, because these factors should affect the rental as well as the owner-occupier markets. The fact that prices are rising much faster than rents suggests that homes are being bought in the expectation of capital appreciation rather than underlying fundamentals. That is the definition of a bubble.

Some analysts argue that lower interest rates justify a higher p/e ratio. The same argument was made in the late 1990s for equities. But if rates are low because inflation is low, then future rents will also rise more slowly. Future rents should therefore be discounted using real interest rates, not nominal rates. As argued above, real interest rates in America or Britain are not particularly low.

The p/e ratio is probably the best measure by which to judge whether houses are overvalued, because it tries to value housing like other assets. But it is hard to get reliable, long-run series of rents for all countries. Moreover, in many continental European countries rents are still partially regulated by the government. If the p/e ratio proves difficult to obtain, another useful measure is available:

• The house-price-to-income ratio. The ratio of average house prices to average incomes, which tracks the long-term affordability of homes, is currently flashing red in America, Britain, Australia, Ireland, the Netherlands and Spain. In all these countries the ratio is close to or above previous peaks—ie, levels that preceded previous crashes (see chart 9).

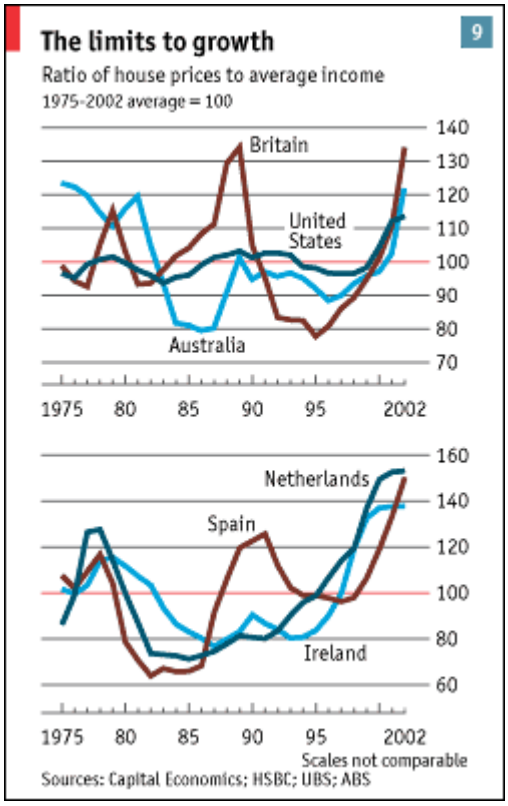
Awkwardly, this ratio is sensitive to the exact measure of income used. In America the ratio of average home prices to average personal disposable income is only 5% above its long-run average. But Ian Morris, an economist at HSBC, a bank, reckons that the ratio of average house prices to median household income is a better measure, because it reflects the circumstances of the typical home-buyer and avoids the distortions introduced by a few very rich people. This ratio is currently at a record high, 14% above its long-run average.

Mr Greenspan insists there is no “national” housing bubble in America, and indeed houses across the country are on average less overvalued than elsewhere. But if a bubble were to burst in several cities simultaneously, that would have big national

consequences. Using the ratio of house prices to income, a recent analysis by Michael Youngblood, director of research at GMAC-RFC Securities, identified potential bubbles in 55 of the 210 metropolitan areas that he examined.

For the euro area as a whole, the average house-price-to-income ratio is slightly below its long-term average, but this is mainly because in Germany houses on this measure look significantly undervalued. In France, Italy and Belgium the ratio is close to its long-term average. In Spain, the Netherlands and Ireland, however, it is 40-50% above it.

Ireland and Spain differ from most of the other bubbly housing markets in that real mortgage-interest rates fell substantially in the run-up to euro membership. This may justify a higher ratio of house prices to incomes. But how much higher?



All of the six countries where houses appear to be overvalued (America, Britain, Australia, Ireland, the Netherlands and Spain) also share another bubble-like symptom: an explosion in mortgage borrowing in recent years. Australian household debt has jumped from 55% to 130% of personal disposable income over the past decade. In the Netherlands the ratio has almost doubled to 180% of disposable income over the same period. The average new mortgage there is 110% of the value of a home, because lenders are happy to finance all the purchasing costs, including stamp duty and fees. In America, 21% of mortgages last year were for more than 90% of a home's purchase price, up from 7% at the peak of the boom in the late 1980s. This means that if prices were to drop, more households would be left with debts exceeding the value of their home than were a decade ago.

A sticky situation

Comfortingly, many economists believe that house prices will level out rather than collapse. In America, national average house prices have never fallen for a full year during the past three decades. Unlike share prices, house prices tend to be sticky downwards. The usual explanation for this is that people have to live somewhere and transaction costs are high, so they will not sell even if they think their home may be worth less next year. Owners are also loth to accept a capital loss. As long as they can meet their mortgage payments, they will stay put until conditions improve. So the volume of sales will decline, but prices will not.

However, countries other than the United States have seen falls in average house prices over past decades. And even within America there have been regional busts, for example in Boston, Manhattan and San Francisco in the early 1990s, where prices dropped by 15-20%.

The optimists still maintain that house prices do not have to fall to restore the relationship between house prices and rents or incomes. All it needs, they argue, is for house prices to stay constant as incomes and rents rise. This is how most of the adjustment after previous house-price booms has been achieved. But now inflation is so low that gradual adjustment would take too long, so nominal prices are much more likely to drop.

Take Britain, where house prices appear to be more than 30% overvalued relative to their long-term trend. If house prices stay constant and wages grow by 3% a year, it will take ten years to bring the ratio of prices to income back to its fair value. Moreover, history shows that after a boom prices usually undershoot their fair value. If the ratio of house prices to income were to plunge to its trough of the last cycle, then even with rising incomes average nominal house prices would slump by almost 40% over four years. That would be overdoing it, but a price fall of 20-25% looks likely.

Table 10 takes a guess at how far prices might fall in the six countries with suspected housing bubbles. The first column estimates the amount by which houses are overvalued (relative to the average of the past three decades), based on both the price-to-income ratio and the price-to-rent ratio where available. Our

forecast allows for a 10% rise in the equilibrium level of house prices in Ireland and Spain, as a result of lower real interest rates. It also assumes that over the next four years wages (and rents) will grow by 3% a year in America, Britain, Australia and the Netherlands and by 4% in Ireland and Spain, helping to restore the link between house prices and incomes; and that prices will undershoot their fair value by 5-10%. The end result of these calculations is that average house prices in America could fall by 10% in money terms over the next four years and those in the other countries listed by 20-30%. If America and Europe were to suffer a spell of deflation, as some economists fear, prices would plunge even more steeply.

Waiting for the crash 10

Average house prices

	% over-valuation relative to 1975-2002 average*	% price fall forecast over 4 years†
Australia	31	-20
Britain	34	-25
Ireland	42	-20‡
Netherlands	44	-30
Spain	52	-30‡
United States	15	-10

*Based on average of house prices/income and house prices/rent ratios †Assumes: prices undershoot by 5-10%; annual wage inflation 3%, except Spain and Ireland 4% ‡Assumes 10% rise in equilibrium price

Source: *The Economist*

These are averages across the whole country, but some regions are more overvalued than others. A 20-25% average price decline in Britain could imply a fall of over one-third in London house prices but a much smaller drop in the north. In America prices in New York, San Francisco and Boston might drop by 20% or more.

A bigger drop in nominal prices is also that much more likely this time because so many more people have been buying houses as an investment. In Australia, investors accounted for over 40% of all housing loans approved last year, up from 18% in the early 1990s. In London, one in eight housing transactions in recent years was for investment. If house prices start falling, owner-occupiers who can afford to meet their interest payments will stay put, but investors are more likely to sell—especially if rents do not cover their interest payments—putting further downward pressure on prices. The abundance of cheap rented property is also affecting the market in another way. Anecdotal evidence in London and Sydney suggests that some owner-occupiers are selling and renting to lock in a profit before prices fall.

The optimists still maintain that previous house-price booms turned to bust only because central banks sharply raised interest rates, so buyers could no longer afford to service their mortgages. This time, with inflation so low, interest rates are unlikely to rise significantly, they say. Perhaps; but Japan and Germany show that low interest rates are no protection against a decline in house prices.

All that is required to burst the bubble is a change in sentiment. Just as investors in the stockmarket eventually decided that enough was enough, at some stage would-be home-buyers will refuse to pay ridiculous prices. In many countries, first-time buyers are now finding it impossible to get on the bottom rung of the property ladder because they cannot scrape together the deposit. In Britain, mortgage lending to first-time buyers has fallen sharply this year. As demand at the lower end dries up, the whole market could quickly turn. And if prices start to dip, one good reason to buy—the expectation of capital gains—will disappear, pushing prices even lower.

Mr Greenspan says that any analogy between house prices and the stockmarket bubble is “a rather large stretch”. He needs to exercise his imagination. House prices in America and other economies are unlikely to fall as precipitously as share prices have done over the past three years, but even a much smaller drop could do more serious economic harm.

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Design flaws

May 29th 2003
From The Economist print edition

Why property markets suffer from bubble trouble

IS THE housing market less prone to bubbles than the stockmarket? Alan Greenspan thinks so, arguing in a recent speech that the transaction costs of buying and selling a home are much higher than in the stockmarket and that this is likely to discourage speculative trading in houses. Moreover, he says, arbitrage opportunities are much more limited in housing markets than in securities markets. A home in Portland, Oregon, is not a close substitute for a home in Portland, Maine, so even if a bubble were to develop in a local market, it would not inflate a national bubble.

Yet many economists take the opposite view: that bubbles are in fact more likely to develop in housing markets than in stockmarkets. Some academics go so far as to argue that stockmarket bubbles are impossible because financial markets are efficient, in the sense that prices reflect all publicly known information about an asset. But even these economists would concede that property markets, both residential and commercial, are inefficient. They are illiquid, trading is infrequent, assets are heterogeneous (both by location and by type), transaction costs are high, and information is imperfect because there is no central exchange. These market imperfections should make property bubbles more likely, not less.

Work by Karl Case at Wellesley College and Robert Shiller at Yale University has confirmed that the market for housing is indeed inefficient. They found substantial positive serial correlation in movements in home prices: price changes in one year tend to be followed in the next year by changes in the same direction. In an efficient market, asset prices should change instantly to reflect new information.

Persistence in the direction of house-price changes suggests that expectations are set by looking backward: prices are expected to rise because they have done so in the recent past. Other studies have found that to some extent it is possible to predict future house-price movements from information available now, namely past price increases and the deviation of prices from their long-run trend. In an efficient market that would be impossible.

Richard Herring and Susan Wachter, both economists at the Wharton School of the University of Pennsylvania, point to three distinctive features that make property markets particularly prone to bubbles:

• The absence of short-selling. The supply of real estate is fixed in the short term, so increased demand from a few optimistic investors will push prices above their equilibrium level. In an efficient market, such as that for shares or foreign exchange, such price rises would be moderated to some extent by other investors selling short (selling something for future delivery that they do not currently own, in the hope that they will be able to buy it more cheaply later). But there are no organised futures or options markets for property. In such a market, with no short-sellers, prices will be driven by the optimists so long as the upward trend continues.

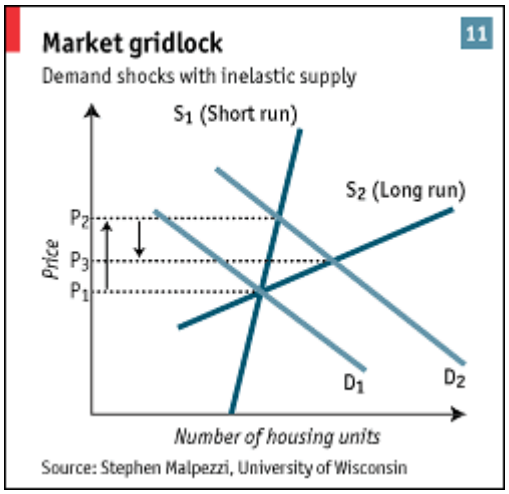
• Construction lags. In a well-functioning market, the price of property should bring demand and supply into equilibrium. If a surge in demand pushes the price of existing property above its replacement cost, developers have an incentive to build more. But new properties take years to complete. By the time the houses or offices are built, demand may have fallen, so prices will slump. Worse still, because of the lags, supply will for a period continue to increase even as prices decline, pushing them lower. These supply lags encourage a boom-bust cycle.

• The perverse incentives of lenders. Banks have an incentive to lend as much as possible when property prices are rising, but then to pull out when prices fall, exacerbating both the boom and the bust. Rising house prices lift the market value of collateral on banks' existing loans, so they are willing to lend more, pushing prices higher. Higher prices also lift the value of banks' own property holdings and hence their

capital, which encourages them to relax their lending standards. If prices fall, this process goes viciously into reverse, and a credit crunch can amplify the impact of falling prices. Property booms are much more closely linked with credit growth than stockmarket booms.

All this makes it easy to see how a property-price bubble can develop. A genuine increase in demand will raise prices because supply is fixed in the short term. If buyers' expectations about future prices and lenders' willingness to extend credit are both based on recent price increases, demand will then rise further, pushing prices higher still. Eventually, supply will expand and prices will start to fall, pushing the whole process into reverse. The role of supply is crucial in this process. Much of the analysis of movements in house prices concentrates only on demand factors, such as interest rates and the rate of growth in population and incomes. Yet a growing body of research suggests that the volatility of house prices is determined less by demand than by supply.

In a recent paper Stephen Malpezzi, an economist at the University of Wisconsin, and Susan Wachter demonstrate the importance of supply conditions in the formation of house-price bubbles. Markets with strict planning controls or natural constraints on building are much more prone to booms and bust. Chart 11 assumes a property market where in the short to medium term supply is almost completely inelastic (ie, unresponsive to changes in price), partly as a result of planning controls. If demand rises and the demand curve shifts up from D1 to D2, prices jump from P1 to P2. Over the longer term, however, the supply curve is more elastic: developers decide to build on land which already has planning permission, and the government relaxes planning restrictions. The supply curve shifts from S1 to S2 and prices fall sharply, from P2 to P3.



If, on the other hand, the short- to medium-term supply curve is more elastic, the supply of housing will expand more rapidly to meet any increase in demand. Prices will initially rise by less and subsequently fall by less, and the cycle will be moderated.

In the very short run, supply is fixed everywhere. But a study by Mr Malpezzi and Duncan Maclennan, of Glasgow University, suggests that in the medium term supply is much more responsive (ie, the supply curve is less steep) in America than in Britain, where planning regulations are stricter. This may partly explain why housing booms and busts are more common in Britain. In densely populated cities where land is scarce, such as New York and London, supply is particularly constrained, so bubbles are also more likely.

Fixed but adjustable

Some past housing-market forecasts have come badly unstuck because of economists' tendency to concentrate on demand and ignore supply. One widely noted study in the late 1980s predicted that the ageing of America's population would cause real house prices to fall by 47% over the following 20 years, because older people tend to downsize to smaller, less expensive homes. In the event, demand for housing did not fall, and neither did prices. But even if the demand for housing were to decline, supply would eventually shrink too, because in the long run the nationwide supply of housing is almost perfectly elastic.

More recent studies suggest that in the long run demographics tend to have a relatively modest effect on house prices. This is why the popular claim that rapid population growth will result in ever-rising house prices is nonsense. The long-run impact of rising demand on prices depends on how supply responds. America has had much faster population growth than Britain, yet over the past two decades real house prices in Britain have risen four times as much as in America.

All this suggests that if governments want to prevent bubbles, they need to pay attention to supply as well as to demand. Easing up on planning regulations could help to keep down the size of future bubbles, but it is unlikely to prevent them altogether. Property markets are inherently prone to boom and bust.

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Risky office affairs

May 29th 2003
From The Economist print edition

Investors have rediscovered commercial property

DOES the commercial-property cycle dance to the same beat as the housing market? Just as households have come to see their home as their best investment, investors have also changed their view of commercial real estate. Property has traditionally been regarded as illiquid, and a spectacular collapse in prices in the early 1990s scared many away. But now investors are again pouring money into the sector. Is this wise?

Prices of commercial property have always been more volatile than those of housing, partly because the supply lags are longer. Developers plan new buildings when prices rise, but it often takes years to get planning permission and to construct a building, by which time demand may have fallen. Booms and busts in commercial property caused widespread banking problems in the early 1990s, when property prices fell by 50% in America and Britain and by 70-80% in Japan and Sweden. The bursting of a huge property bubble was also a prime cause of Thailand's financial crisis in 1997-98.

The late 1990s saw another surge in property values (see chart 12). The market has since softened somewhat, but strong investor demand has helped to keep prices quite high. Indeed, in some cities properties have been changing hands at near-record prices over the past year. It seems that investors have failed to notice that the underlying fundamentals of the commercial-property market have turned sour.

This is especially true of office space. New construction has not been as reckless as in the previous cycle, when supply exploded, but in many countries the slump in demand has been more severe. Figures published by Reis, a property-research firm based in New York, show that the volume of occupied office space in America has already fallen for two consecutive years and declined again in the first quarter of this year. This indicates a serious malaise: in the previous two recessions there was never an overall annual decline in office use. Most of this drop in demand has been in the IT and financial-services sectors. Since 2000 the national vacancy rate has more than doubled to 17%, not far below its 19% peak in 1991.

Nationally, average office rents have fallen by 18% from their peak, but in San Francisco, Boston and New York the decline has been 60%, 30% and over 20% respectively. Effective rents have fallen by even more, because landlords are offering generous concessions. Silicon Valley a few years ago had some of the world's most expensive offices, but the bursting of the tech bubble has taken a heavy toll. One-third of buildings now stand empty.

To let

Across Europe, too, vacancy rates are rising and rents are falling. In the City of London and Frankfurt rents have fallen by almost 30% from their peak. Frankfurt's high-rise market is crumbling as the German economy stagnates, the country's troubled domestic banks slim down and foreign banks pull out. Despite shrinking demand, Frankfurt office space is due to increase by almost 10% by the end of next year as new developments are completed.

Peter Damesick, head of research at Insignia Richard Ellis, a British property consultancy, says the slump in demand for office space in the City of London is already as bad as in the depths of the 1990s crash,

and there could be worse to come. The City's vacancy rate (including new developments) has risen to 16%, up from 2% in 2000. As yet, this is not as bad as in the early 1990s, when the vacancy rate hit almost 20% and rents fell by 50%. But City rents are likely to drop further.

Olympia & York, the original developers of the Canary Wharf complex in East London, went bust in the early 1990s, thanks to a glut of new offices. In March the Canary Wharf Group revealed that it had more empty offices than previously admitted. Signed-up tenants of buildings under construction have the unusual option to return unwanted space, and many banks are likely to do so. Much more property than expected will therefore come on to the market over the next year.

Although there has been less new construction this time, the peak of new office completions (planned during the boom) has not yet been reached. Almost 1m square metres of new office space will come on to the London market this year, twice last year's total. To take one example, the “erotic gherkin”, a 41-storey cigar-shaped building in the heart of the City, is due to be completed by the end of this year. Designed by Lord Foster, it was subject to a fierce planning battle which Swiss Re, its owner, may now wish it had lost. The company is struggling to let the half of the building it does not need for itself.

Worldwide, there has been less speculative development than last time; instead, most new buildings already have an anchor tenant or substantial pre-leasing. But this time it was largely the tenants rather than the developers who got carried away. Firms in IT and financial services were wildly over-optimistic about their growth prospects, signing up for space which they now find they do not need, and having to pay for it. The need to sublet is putting lots of these properties back on the market.

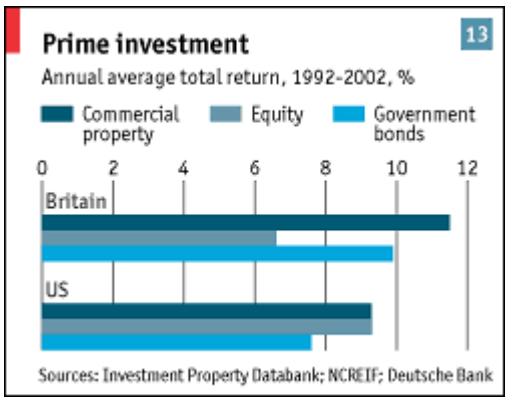
Some analysts take comfort from the fact that, in contrast to previous cycles, the fall in rents is due mainly to weak demand rather than excess new supply. But who knows whether demand will recover? Employment in financial services, IT and telecoms is unlikely to return to its previous levels for many years, if ever. Cash-strapped firms in every sector are cutting costs by trimming the amount of office space per worker. And, in America at least, faster productivity growth means that fewer jobs are created when GDP increases, and so fewer new offices are needed.

Only disconnect

Despite falling rents, investors in America and Europe have been pumping large amounts of money into commercial property. Traditionally, falling rents have caused an even sharper fall in property prices because investors demand higher yields (rents divided by capital value) to compensate them for the perceived risk of capital loss. But this time, thanks to strong investment demand, prices have fallen a lot less than rents, or even continued to rise in some cities. According to Bob White, at Real Capital Analytics, a New York company that tracks real-estate investment sales, the average price per square metre in Manhattan rose by 12% last year, whereas rents fell by about 10%. Strong competition from investors has resulted in record prices on some deals: Citigroup's headquarters, at 399 Park Avenue, fetched over $1 billion late last year. In Britain and Germany, too, prices are holding up better than rents.

Pension funds, life assurers, private investors and investment trusts are all increasing their exposure to property. They are disillusioned with equities, and do not see much scope for further big gains from bonds. But the disconnect in the property market between strong demand from investors and weak demand from tenants is worrying—especially when some of the motives driving investors are flawed.

Some analysts claim that property has a higher long-term average return or a superior risk-return trade-off than other assets. Over the past ten years the total return on unleveraged investment in American property has outpaced the return on bonds and exactly matched the return on shares. (Leveraged investments would have beaten shares.) In Britain, commercial property has shown a higher return than both shares and bonds (see chart 13). Over the decade, property returns were also less volatile than those on other assets. But this superior performance cannot be maintained indefinitely. Every investor knows that the higher the return on an asset, the greater the risk. If a low-risk asset were to offer a higher return, it would quickly be arbitraged away. Research by CSFB, a bank, shows that over the past 80 years returns on British property were less volatile than those on equities, but at the cost



of a lower annual average real return: 5.3%, compared with 7.6% from shares.

More surprising, over those 80 years property not only produced a higher average real return than gilts (2.8%), but it was also less volatile. The trouble is that the most widely used figures tend to understate the true volatility of property returns because they are based on valuers' estimates of property values, not actual transactions. This tends to smooth out returns over time. If a building is put up for sale and does not attract offers above the reserve price, it will be taken off the market, but it will not immediately be revalued at the best price offered. Standard figures also overstate the return on property because they do not include transaction costs, which are a great deal higher than for paper assets.

Another, equally flawed reason often cited for investing in property is that bricks and mortar are more solid than a paper asset. A firm can go bust and disappear, but a building will remain standing. Yet bricks and mortar have no intrinsic value: a shopping mall at the South Pole is worth nothing. Value lies in the rents that a property can generate, not its physical attributes. Without a tenant, income and hence value disappear.

There are, however, some good reasons for investing in property. First, it has a low correlation with returns on equities and bonds, so holding some of it along with other investments reduces overall risk. Studies suggest that the weight given to property should be at least 20% of a portfolio, depending on investors' risk preferences and time horizon.

Second, a large part of the return from property comes from income rather than capital appreciation, so it appeals to pension funds and insurance companies which require a steady income flow to finance their liabilities. When inflation was high, bond yields were higher than property yields. But rents generally rise in line with inflation, so the percentage yield (income divided by price) is steady, whereas bonds pay a fixed income, so if inflation falls, and hence bond prices rise, the percentage yield falls. All this means that property now generates a higher income yield than bonds. Initial property yields are currently a record 400 basis points above American Treasury bonds.

Property in Britain looks particularly attractive, because leases there are longer than elsewhere, and most of them contain clauses that allow rents to rise but not to fall. This offers a long-term guaranteed income, even if market rents drop. However, real estate is riskier than a bond. It is illiquid, it depreciates physically, the tenant can go bust, and there is no guarantee that the investor will get his money back at the end, as he knows he would with a government bond.

One development that has increased the attraction of property to investors is the growth of indirect investment vehicles, such as America's real-estate investment trusts (REITs). These are publicly traded companies that invest in property and pay no taxes so long as most profits are passed on to shareholders as dividends. For most individuals, buying a whole building is out of the question, but REITs allow small investors to enter the market. They also increase liquidity: investors can buy and sell units on the stock exchange.

The REIT stuff

The total market capitalisation of REITs is now a massive $162 billion, compared with only $13 billion in 1991. Australian listed property trusts and German open-ended property funds have also enjoyed strong inflows of money. The French government has recently passed legislation to allow the setting up of French REITs (jokingly called freits), but in Britain the tax system has discouraged them.

A lot more money could yet flow into property. Only 10% of American employees' 401(k) pension plans offer a REIT option, but the share is rising. Until recently, American pension funds held only 3% of their assets in property. This has now doubled to 6%, but a risk-return model would probably recommend an even higher share. At the end of 2002 British financial institutions had only 6% of their portfolio in property, a share which CSFB reckons the institutions could easily increase to 10%. The Prudential has already raised its target from 12% to 18%.

The attraction to some investors of holding assets with a high, steady income probably justifies some revaluation of property; but the price of a building should still depend on its future rental income. So given strong demand from investors and weak demand from tenants, is another bubble on the way? An analysis by Deutsche Bank concludes that in most countries, commercial-property p/e ratios, calculated as the ratio of property prices to rents, are not significantly out of line with their long-term trend. Bob White at Real Capital Analytics agrees that there is no nationwide bubble in America, but he reckons that

recent transaction prices in Manhattan do look distinctly bubbly.

Another factor shoring up commercial-property prices is that interest rates this time are much lower than in previous cycles. Last time round many owners had to sell as vacancy rates soared because they could not afford to finance empty buildings, so prices plunged. Now, thanks to low interest rates, landlords break even at lower rents and occupancy rates, so there will be fewer forced sales, and prices are less likely to collapse.

Most analysts do not believe that a bubble is emerging. Indeed, many argue that the property market has become less prone to boom and bust, thanks to the expansion in the markets for publicly traded investment trusts and commercial mortgage-backed securities. They think the shift from bank finance to public capital markets has made the property market less speculative and more disciplined, by increasing the flow of information about demand and supply and by encouraging greater scrutiny by analysts.

This is wishful thinking. In London and New York the recent trough-to-peak increases in property prices were almost as large as in the late 1980s. Long construction lags are at the root of property booms and busts, and these will remain. Moreover, after the dotcom and telecoms bubbles, there must be strong doubts about the ability of capital markets to discipline flows of investment capital.

Lloyd Linford, the chief executive of Reis, scoffs at claims that the commercial-property market has been tamed. It is true, he says, that there was less speculative development than usual during the recent boom, but the decline in new developments as demand from occupiers collapsed has also been smaller than usual. In previous downturns, developers were forced to halt projects as finance dried up. Today large amounts of capital continue to flow into real estate, allowing construction to be sustained at higher levels. That may mean it will take longer to clear excess supply, and office vacancy rates will stay high for longer, pushing rents even lower. How long before investors and developers realise that the laws of supply and demand have not been scrapped?

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May 29th 2003
From The Economist print edition

Companies are seeing their premises in a new light

BUILDINGS are as essential to a company's operation as workers and machines, yet until quite recently property rarely rated a mention in the boardroom. Even though for most firms property is the second-biggest business cost after wages, directors often had no idea what their property was really costing the firm. That is changing.

Traditionally, companies have owned their premises, but there is no better reason for them to own property than to own their billing system or their cleaning service. Indeed, having money tied up in property can reduce a firm's overall return on capital, so many firms are now selling their entire property portfolio to investors and leasing buildings back. The prime motive is usually to raise money to reduce debts and to flatter profits. It is no coincidence that Europe's heavily indebted telecom firms, such as BT and Deutsche Telekom, have been eager to rejig their ownership of real estate.

In theory, the future cost of leases should be capitalised and recorded on the balance sheet, because firms are committed to paying rent for the term of the lease even if they do not need the space. That makes rent commitments as much of a liability as debt. Standard & Poor's, a credit-rating agency, counts the capitalised value of operating leases towards total debt if firms disclose the data. But as recent experience has shown, companies' financial accounts are rarely as transparent as their glass-fronted offices.

Another benefit of sale and leaseback is that having to pay an explicit market rent encourages a company to use its space more efficiently. Firms that have always owned their offices tend to treat them as if they were free. Once managers realise that the implicit cost of property in central London, say, is a hefty £20,000 ($32,400) per employee per year, they become more careful with office accommodation. According to a report by the Royal Institution of Chartered Surveyors, the average tenant uses 12% less space per worker than the average owner-occupier.

A study by City University Business School found that companies with mainly leasehold property financially outperformed those that owned their premises. In Europe over two-thirds of offices are owner-occupied, compared with only one-third in America. Perhaps more European companies should give would-be property investors a chance.

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Heading for a brick wall

May 29th 2003
From The Economist print edition

Can future housing bubbles be prevented?

IF SOMEONE had told you three years ago that share prices in America and Europe would plunge by almost 50%, you would have braced yourself for a deep global recession. One reason why many economies have held up better than expected is that rising house prices have offset the loss of equity wealth and so helped to support consumer spending. Indeed, in America housing is arguably the only remaining prop for the economy. But by keeping interest rates low to cushion the economy from a slump in share prices, some central banks may have inflated a housing bubble. America, Australia, Britain, Ireland, the Netherlands and Spain look most at risk.

Yet even as house prices start to wobble, many housing experts continue to insist that "this time is different": because interest rates will not rise significantly in the near future, they say, a slump in house prices is unlikely. This survey has argued that even if interest rates stay low, house prices could tumble, undermined by dwindling demand from first-time buyers and waning confidence. However, the experts are right to say that this housing boom is different from previous ones, in two worrying ways. First, inflation today is close to its lowest for half a century. This means that overvalued house prices cannot regain their long-term equilibrium mainly through inflation, as they have done in the past. Instead, house prices will have to fall by at least 20% in money terms in most of the countries with bubbles.

A second important difference is that this time the surge in house prices has gone hand in hand with a proportionately larger jump in household debt. Not only are new home-buyers taking out large mortgages as a percentage of the purchase price, but existing owners have taken advantage of rising house prices to increase their mortgages and turn some of their capital gains into spending money. In America, Britain, and Australia mortgage-equity withdrawal is running at record levels of 5-7% of personal disposable income.

A bubble can never be positively identified until after it has burst, but the rapid increases in both house prices and mortgage debt should set alarm bells ringing. Either way, consumers are living on borrowed time. Even if house prices simply flatten off, the scope for mortgage-equity withdrawal and hence consumer spending will slow sharply. If, as seems more likely, house prices fall, the recent borrowing binge means that more people than ever before will find their homes are worth less than their mortgages.

Prepare for impact

Even those with a small mortgage will be hit, because for most people their home is by far their most important asset. In particular, a sharp fall in house prices will be another blow to those about to retire. Their pensions have already been battered by the stockmarket crash, and if they were planning to supplement them by selling a home or by taking out an annuity against it, they will find their nest-egg is worth less than they had expected.

A fall in house prices would also lead to a rise in mortgage defaults. In the past, the biggest victims from a housing bust, other than the borrowers themselves, were the banks and savings institutions. Today American banks sell mortgages in the secondary mortgage market, mainly to two government-sponsored agencies, the Federal National Mortgage Association (affectionately known as Fannie Mae) and the Federal Home Mortgage Loan Corporation (Freddie Mac), which finance their purchases by issuing bonds or by pooling mortgages and selling them as mortgage-backed securities. This has allowed banks to make even more housing loans, helping to fuel the bubble.

This time the banks themselves are less exposed to a property bust, but the sheer size of Fannie Mae and Freddie Mac (which at the end of 2002 accounted for 44% of all mortgage debt) could pose a risk to

the whole financial system. If house prices fell, some of the mortgages they hold in their portfolio could go into default and they would not have enough cash to pay the holders of their bonds. The agencies' debt is priced as if it were guaranteed by the government, yet there is no explicit guarantee, so it is not clear whether the government would bail them out in a crisis. A default on their bonds would have serious knock-on effects because mutual funds, banks and savings-and-loans institutions are all large holders. But the cost of a bail-out could dwarf any previous ones.

If the housing bubbles burst, the economic consequences will be much more severe than those of the recent stockmarket crash, because more households own homes than own shares, and because home-owners are up to their necks in debt. Ominously, Japan's property-price bubble burst a couple of years later than did its stockmarket bubble, and the massive wipe-out of wealth that resulted has been partly responsible for a decade of economic stagnation. Many will argue that Japan was an exception. There are certainly differences, notably that Japan's banking system was in a much worse state to start with. But there are also some similarities. The most worrying is that with interest rates already close to zero, America's Fed now has little room left to cut interest rates if the economy were to run into trouble. A housing bust might therefore nudge the economy into deflation.

Shoring up the foundations

If the housing boom ends badly, policymakers will need to draw lessons about how to reduce the risk of future bubbles. A first requirement is the provision of better data on house prices, rents and new construction to improve market transparency. In most countries the most up-to-date statistics are collected by private-sector lenders or estate agents, who tailor data to their own needs. Official statistics offices typically collect more information about the price of shoes or cement than housing, despite its far greater economic importance.

A second requirement is for more research on what drives house prices, why prices are more volatile in some countries than others, and what effect changes in house prices have on consumer spending. Traditionally, economists have found property a less glamorous subject than stockmarkets. It is certainly less financially rewarding, because investment banks have traditionally had little interest in it. That will have to change.

A third lesson is that central banks should sometimes tighten monetary policy in response to sharp increases in asset prices even if inflation is low. Central bankers' fixation on consumer-price inflation in recent years has blinded them to other important signs of financial and economic imbalance. They have ignored the build-up of excess liquidity, which instead of pushing up inflation has spilled over into asset markets: first the stockmarket and now housing.

It is true that if the Fed had not slashed interest rates after the stockmarket collapsed, the downturn would have been much steeper. But by inflating a house-price bubble and encouraging households to borrow more, the Fed has merely delayed the day of reckoning. With households now even more deeply in debt, a fall in house prices would have even more serious consequences.

As an alternative to raising interest rates to curb a housing bubble, governments could discourage excessive borrowing by limiting the size of a home loan as a proportion of the purchase price. Not only would this help to prevent home-buyers ending up with negative equity if prices fell, it could also help to moderate booms and busts. The maximum size of a loan could be reduced when house prices are rising rapidly, helping to cool the market, and raised in a downturn.

Some analysts have blamed the boom-bust tendency of housing markets on the tax reliefs that home-buyers in many countries enjoy. It may be no coincidence that some of the countries with the most generous tax breaks on buying a home—the United States, Spain, Ireland and the Netherlands—have recently seen strong house-price booms. Yet so has Britain, which phased out tax relief on mortgage interest some time ago, so that cannot be the whole explanation.

Gordon Brown, Britain's chancellor of the exchequer, has now developed different ideas on how to make house prices less volatile. He puts some of the blame on the variable-interest-rate mortgages currently in widespread use in his country, and wants to convert borrowers to long-term fixed-rate mortgages, as widely used in continental Europe and America.

Mr Brown is right to want to shift home-buyers to fixed-rate mortgages if he expects Britain one day to join the euro, because such a shift would reduce the sensitivity of the whole economy to interest-rate

changes. It would not, however, prevent housing booms and busts. Just look at Japan, where 30-year fixed-interest mortgages prevented neither the emergence of the housing bubble nor its popping a decade ago. In Britain, a more important reason, perhaps, why house prices are so volatile is that supply is less responsive to changes in price than in many other countries, partly because of planning regulations. If policymakers want to even out booms and busts, they need to ensure that supply responds more promptly, as well as raising interest rates to dampen demand earlier in the cycle.

So much for lessons for policymakers; what advice is there for home-buyers? Anyone thinking of buying in any of the housing markets that this survey has identified as bubbling should wait until prices have fallen. Anyone who already owns a home but has to move for work or family reasons should consider selling and renting until prices drop. Most home-owners, however, will have to stick it out and watch their wealth dwindle. Their mistake was not to buy a home, because they can still enjoy living there. Where they went wrong was in expecting double-digit returns to continue, and to make decisions on that basis, such as taking out a second mortgage to support a more lavish lifestyle, or neglecting to save for retirement. In a world of near-zero inflation, double-digit returns are no more sustainable on houses than on equities. Next time an exuberant estate agent tells you that bricks and mortar are the safest thing you can invest in, hit him on the head with this copy of *The Economist*.

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May 29th 2003
From The Economist print edition

This survey draws on many sources and interviews. In addition to those cited in the text, the author would particularly like to thank CB Hillier Parker; Cushman & Wakefield; the Corcoran Group, New York; B.J. Droubi & Co, San Francisco; Sarah Lorden Real Estate and McGrath Estate Agents, Sydney; Foxtons Estate Agents, London; UBS Warburg; Michael Ball, Reading University; John Krainer, Federal Reserve Bank of San Francisco; Louis Taylor, Deutsche Bank Securities; and Julian Callow, CSFB.

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May 29th 2003
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Wireless telecoms

Move over 3G: here comes 4G

May 29th 2003 | SAN FRANCISCO
From The Economist print edition

Third-generation (3G) mobile-phone networks face a new rival: so-called 4G. And, astonishingly, the new networks may even be profitable

Get article background

"THE future always comes too fast," Alvin Toffler, an eminent futurologist, once said, "and in the wrong order". The state of wireless telecoms is a classic example. Even as "third-generation" (3G) mobile networks are being switched on around the world, a couple of years later than planned, attention is shifting to what comes next: a group of newer technologies that are, inevitably, being called 4G. More hubris from the technology-obsessed industry? Not exactly. Some 4G networks are operating already, with more on the way. A technology once expected to appear around 2005 is here now.

Interest in 4G owes much to the mess surrounding 3G. Operators spent *euro*100 billion (about $100 billion) buying licences to run 3G networks, only to find that the technology that most had agreed to use was harder to implement than expected. Even where 3G networks are up and running, demand for the snazzy video and multimedia services they make possible is still uncertain. Expectations are being scaled down: 3G could end up merely as a way for mobile operators to boost their capacity for voice calls in overloaded parts of their networks, rather than a goldmine of new revenues from multimedia services. Last week, mmO2, a European operator, wrote down the value of its 3G investments by nearly $10 billion—although this week, despite reporting a pre-tax loss of $9.6 billion (reflecting write-downs of goodwill related to acquisitions), Vodafone chose to postpone its inevitable 3G reckoning.

As 3G has stumbled, another wireless technology, called Wi-Fi, has inspired a mania unseen since the great internet boom. Wi-Fi provides high-speed internet access to suitably equipped computers within 50 metres or so of a small base-station. It is widely used in homes, offices and universities. Several firms offer fee-based Wi-Fi access in airports, coffee-shops and other public places known as "hotspots". But because of the short range of Wi-Fi technology, universal coverage is impractical. Although a dozen or so start-ups are working on ways to extend the range of Wi-Fi, it now takes hundreds of Wi-Fi base-stations to cover the same area as a single mobile-phone base-station.

Best of both worlds

But what if you could combine Wi-Fi-style internet access with the blanket coverage, and fewer base-stations, of a mobile network? The various 4G technologies developed by such firms as IPWireless, Flarion, Navini, ArrayComm and Broadstorm offer just such a blend. There is no formal definition of 4G, but what such technologies have in common, says Andy Fuertes, an analyst at Visant Strategies, a research firm, is that they are high-speed wireless networks covering a wide area, designed above all for carrying data, rather than voice or a mixture of the two. They can pipe data to and from mobile devices at “broadband” speed, typically 10-20 times faster than a dial-up modem connection.

Such 4G wireless-broadband systems can be seen in two ways: as a rival to Wi-Fi that offers wider coverage, or as a wireless alternative to the cable and digital subscriber-line (DSL) technologies that now provide broadband access to homes and offices. Mostly, the wireless operators evaluating 4G see it as the first, and fixed-line telecoms operators as the second. But the convergence of wireless and broadband, argues Chris Gilbert of IPWireless, is actually entirely new: a fast internet connection that follows you around. Navini calls it “nomadic broadband”; ArrayComm's term is “personal broadband”. Mike Gallagher of Flarion, a firm backed by Cisco, likens Wi-Fi to cordless phones that work within a limited range of a base-station, whereas 4G is akin to mobile phones that work anywhere.

Numerous 4G technologies are working today. The first commercial deployments are in parts of America, Canada, New Zealand, South Korea, Germany, Italy and the Netherlands. Vendors are licensing 4G to telecom-equipment makers such as Alcatel, Nortel and LG Electronics for high-volume production. So far none of the 4G vendors has secured the endorsement of a leading “tier one” operator for a nationwide deployment, but many claim to be close to this goal.

Regulatory and technical differences will determine which technologies are likely to be adopted where. Flarion's technology is well-suited, for technical and regulatory reasons, to both America and South Korea. In Europe, the IPwireless system may appeal more. When mobile operators bought their 3G licences, extra spectrum for high-speed data services was often thrown in, and IPwireless's technology uses this spectrum. (IPWireless's technology uses a protocol that technically falls within the European definition of 3G.) Flarion and other vendors hope that Europe's regulators will relax the rules to allow their technologies to be used in this 3G spectrum too. In South Korea, operators have tested every 4G technology; which will be adopted depends on the regulators, who are due to decide later this year.

Advocates of 4G technology argue that, unlike with 3G and Wi-Fi, the business case for 4G is sound. 3G was predicated on consumer demand for multimedia services that may never materialise. Nobody is sure how commercial Wi-Fi hotspots will make money—the number of connections per day at most hotspots is still tiny—yet even so a “land-grab” is under way, with dozens of operators rushing to build thousands of hotspots. But 4G is being priced like fixed-line broadband, a service for which millions of users worldwide are already willing to pay about $50 a month. Emphasising speed first and mobility later, 4G networks may be built initially in regions where cable and DSL are unavailable, to capitalise on pent-up demand for broadband, then expanded later to provide blanket coverage for mobile users.

4G could thus prove a very disruptive technology indeed. Fixed-line and cable operators will face a new competitor in the broadband market. Wi-Fi hotspots will seem hopelessly limited. Mobile operators will find that there is yet another hole in their 3G business plans. Unless, that is, they decide to embrace 4G as the technology that 3G should have been all along.

Some operators may be leaning in this direction. In America, Nextel, a mobile-phone operator, is said to be considering skipping 3G altogether in favour of Flarion's 4G system. In Europe, some operators may scale back 3G plans and adopt IPWireless's technology. As their 3G licences entitle them to do this, they may not be as worthless as they now seem. Mobile operators already own the key sites for base-stations, unlike fixed operators or new entrants, so they are well-placed to build 4G networks fast. They are already attacking the fixed-line voice market. 4G would let them attack the broadband market too—and neutralise the Wi-Fi threat.

It is not clear how investors would judge an operator that decided to favour 4G over 3G. So far, operators have kept quiet about their 4G plans, to avoid confusing the marketplace. Yet when Telefonica, a Spanish operator, abandoned some of its 3G investments last year, its share price went up, notes Mr Fuertes. For phone network operators willing to give it a try, skipping a wireless generation might not be such a bad idea.

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British airlines

Virgin on the ridiculous

May 29th 2003
From The Economist print edition

British aviation seems to be in turmoil. Seems

GIANT hailstones battered a bmi flight over Germany this week, cracking the windscreen and making a hole in the nose. Passengers were pinned to the roof as the pilot dived to escape the storm. The airline (formerly known as British Midland) has itself been taking a battering. Not only is it sharing the misery of the industry; it has also failed to win permission to fly across the Atlantic from Heathrow. This leaves Britain's second-largest mainstream carrier confined to a short-haul network in a European market that is now ultra-competitive thanks to the arrival of a flock of low-cost carriers (LCCs). Squeezed between big airlines and their LCC rivals, bmi has been forced to launch its own LCC, known as bmibaby. But this risks cannibalising its mainstream flights.

It is seeking a way out by linking up with Virgin Atlantic, which specialises in long-haul travel and is desperate for more slots at Heathrow. Bmi has 14% of Heathrow's slots, second only to British Airways (BA), with 38%. A merger with Virgin would allow these slots to be used for more profitable long-haul flights, but preliminary talks about a deal went nowhere. Not least of the obstacles is that Singapore Airlines owns 49% of Virgin, and Lufthansa and SAS between them own nearly 50% of bmi. But the two carriers are still considering joint-marketing by sharing flight-codes and using bmi's European routes to feed traffic to Virgin's long-haul network.

All this was enough to whip up speculation about a possible BA bid for bmi. A bmi-BA pairing could not now get past regulators, as it would account for over half the total slots at Heathrow. It might conceivably pass muster only after the EU scraps national bilateral deals with America, to let the European Commission negotiate on behalf of the whole union. Transport ministers are due to commit themselves to such an EU-wide approach next week.

One rumour even has it that Virgin's founder, Sir Richard Branson (he owns the other 51%), had considered a bid for BA in recent months as its share price plunged. But if anything, the reverse is more likely. Singapore executives privately complain about Virgin, encouraging speculation that it might sell its stake, perhaps even to BA.

No doubt much of the speculation is the work of Sir Richard's perpetual public-relations machine. Reports that he wanted to buy Concorde from BA for a pound vanished once Airbus made clear that it could not afford to maintain the ageing supersonic jet. So Sir Richard needed a new tale. As one airline executive said, “It's all part of his campaign, from the Concorde thing onwards, to be an irritant to BA and garner publicity.”

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South Korean capitalism

A successful failure

May 29th 2003
From The Economist print edition

SK Global may be heading where it belongs—the bankruptcy court

AFP

The end of the road for SK Global?

ON MAY 28th, it looked as though three cheers would soon be in order for South Korea. Foreign investors were preparing a first cheer for the leaders of SK Corp, the flagship company of South Korea's third-biggest family conglomerate, for making only a half-hearted effort to bail out the SK Group's trading subsidiary, SK Global. The second cheer would be for SK Global's creditors, for spurning SK Corp's offer on May 28th and putting SK Global into receivership. The third, and probably loudest, cheer was reserved for the government, for resisting the temptation to "reassure" markets through a misguided rescue attempt. Alas, on May 29th the celebratory mood abruptly changed after the head of SK Group hinted that the parent may mount a last minute rescue bid.

That SK Global found itself in trouble to begin with is a testament to progress. In March it was revealed that the trading firm had overstated profits by $1.2 billion. That was soon after South Korea had sworn in a new president, Roh Moo-hyun, who promised to get tough on dodgy financial practices at the big family conglomerates, known as *chaebol*, and to place openness and respect for minority shareholders at the heart of his economic agenda. Prosecutors indicted the group's chairman, Son Kil-seung, and nine other top executives.

In this new environment, SK Global's parent has faced a stream of questions from the media and investors, eager to know if the group would do what the *chaebol* have almost always done in such cases: use money from another affiliate to bail the subsidiary out.

One investor that has been asking those questions is Sovereign Asset Management, a Monaco-based fund that owns nearly 15% of SK Corp, which is primarily in oil refining and does lots of business with the group's troubled trading firm. Since the trading firm owes 1.5 trillion won ($1.3 billion) of net receivables to SK Corp, and since its other creditors have been prodding SK Corp to write this off or swap it for equity, Sovereign Asset Management has continued to ask how this would be in the interest of SK Corp's shareholders.

That is now an important question in South Korea. Mr Roh has pledged to make it easier for shareholders to file lawsuits against firms that do not safeguard their interests. In the event, worries about shareholders' rights may have led SK Group to make an offer that disappointed SK Global's creditors. It offered to swap only 900 billion won of its receivables for equity. The trading firm's creditors, however, wanted SK Corp to write off the other 600 billion won on top of the debt-for-equity swap, and accordingly rejected the offer. The comments from SK Group on May 29th suggested it may yet oblige them after all.

The government is preparing to issue a $1 billion sovereign bond, and is keen to avoid rattling foreign investors. Fortunately, it seems to grasp that the best way to reassure them is to stick to its policy of more openness. Kim Jin-pyo, South Korea's finance and economy minister, told a gathering of European businessmen this week that the government would not interfere in the SK Global mess and thereby jeopardise the country's "credibility overseas". The new worry is that SK Group will relieve him of the pressure to do so.

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Media bosses under fire

Up to a point, Lord Copper

May 29th 2003
From The Economist print edition

Corporate-governance reform comes to the media

WHY the hounding of Lord Black, boss of Hollinger International, publisher of the *Chicago Sun-Times*, Britain's *Daily Telegraph* and the *Jerusalem Post*? Last week, the newspaper baron was accused of unfairly paying himself and fellow executives $74m, denounced for his extravagant use of corporate aircraft, and forced to end the firm's two-tier share structure, reducing his control. But what is the point of being a media mogul if you cannot fly about in company jets and pay yourself lavishly? As corporate-governance concerns creep up on the last bastion of moguldum, the media, the rule seems to be: baronial excess is fine—as long as your company is doing fine too.

Lord Black's troubles stem from a letter filed with the Securities and Exchange Commission by Tweedy, Browne, a minority shareholder in Hollinger. It demanded that the Hollinger board investigate claims that Lord Black and his fellow executives were paid $74m as part of “non-competition” agreements wrapped into the sale of newspapers in Canada and America since 2000. This money, they say, should have been paid to Hollinger.

Under a layered structure, via Ravelston, a privately held company, Lord Black controls 73% of Hollinger with only 30% of the equity, thanks to his ownership of super-powerful class B shares. In 2002, Lord Black took a salary from Hollinger of $462,460, yet Hollinger paid Ravelston “management fees” of $24m. Lord Black now admits that this arrangement is “not optimal”. Last week he agreed to phase out the class B shares altogether, and to sell up to 10m shares to an American investment firm. His voting control of Hollinger will then shrink to 42%.

The main reason that shareholders have kicked up a fuss about Hollinger's byzantine arrangements is that its newspapers, battered by the industry-wide collapse in advertising, are hurting. Year-on-year operating profits in the first quarter of 2003 fell by nearly a quarter, to $13.5m; the group made a net loss during 2002 of $239m. Noting its heavy long-term debt and other short-term obligations, Standard & Poor's recently downgraded some Hollinger debt to the junkiest of junk.

Had Hollinger been successfully riding out the media slump, investors might have taken less interest in Lord Black's baronial behaviour. Consider two of his rival media moguls, Sumner Redstone and Rupert Murdoch. Despite recent tweaks to comply with new rules, neither of their firms is a model of good governance. Mr Redstone controls about 69% of Viacom through his private firm, National Amusements; Mr Murdoch controls News Corporation with less than 15% of all the shares. Mr Redstone's daughter is still on Viacom's board, though he recently removed his son; both Mr Murdoch's sons sit on News Corp's board. “The animating energy is control,” says Roger Fransecky, of the Apogee Group, a leadership consultancy. “These men know how to manage their boards, and they do it brilliantly.”

In part, they can run their fiefs as they please because they are founder-owners. As Jay Lorsch, a corporate-governance specialist at Harvard Business School points out, this model is particularly prevalent in the media. But it is also because their firms are thriving. Profits have been rising at both News Corp and Viacom, and each has taken advantage of depressed share prices to snap up bargains. Mr Murdoch recently paid a reasonable price for DirecTV, America's biggest satellite-TV company. Mr Redstone has just bought AOL Time Warner's share of Comedy Central, a cable channel, for a snip, and is said to be eyeing the USA and SCI-FI cable channels held by troubled Vivendi Universal.

Similarly, nobody worried too much about the private club that Michael Eisner called a board at Disney, or his fabulous pay packet, until the firm's performance began to falter. As the share price crumbled, Mr Eisner belatedly appeared to understand that a Hollywood film star (Sidney Poitier), an architect (Robert Stern), and the head of the pre-school that his children attended (Reveta Bowers), might not be the most

appropriate directors. All three were removed earlier this year. Mr Stern, Disney conceded, could not be considered independent “because of architectural services that he is providing to Eisner”.

Among newspaper barons, Lord Black is not alone in facing scrutiny. The *New York Times* is reeling from investigations into plagiarism by its journalists—yet another is quitting under a cloud—and there is growing pressure on both Howell Raines, the editor, and Arthur Sulzberger Jr, the family-controlled company's boss. For now, this is limited to editorial concerns. But, with the group's net profits for 2002 down by a third on 2001, the scrutiny of its management may intensify.

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Russian corporate governance

Everyone's a winner

May 29th 2003 | MOSCOW
From The Economist print edition

Minority shareholders are fighting back at big Russian firms

THREE years of wrangling over Russian electricity reform have now produced a remarkably cosy mutual agreement. Anatoly Chubais, boss of Unified Energy System (UES), the state monopoly, had been trying to find sneaky ways to sell some of its generating assets to other oligarchs before it was restructured into separate generating and distribution companies. Minority investors, fearing that their shares in what was left would lose value, were trying to block asset sales and ensure that shares in the broken-up UES would be distributed pro rata to shareholders. But on May 30th, the firm's annual general meeting is likely to approve a plan (passed by the board this week) that seems to leave most people happy.

Its essence is that the government's remaining shares in specific assets, such as local generating companies, will be auctioned—but only to existing UES shareholders. And the currency they will use to bid will be their existing UES shares, which will be swapped for the shares in the assets. This, says Bill Browder of Hermitage Capital, an investment fund with a share in UES, means that he and other minority shareholders have won their fight: their stakes cannot be diluted or devalued, unless Mr Chubais comes up with another trick. Alexander Branis of Prosperity Capital, another shareholder, is less sure: there are still loopholes, he says, that could allow assets to be sold or shares swapped in a way that benefits only the bigger boys.

In fact, this is still a carve-up, if a more polite one. Lately, the industrial firms that want UES's power stations—such as MDM, which supplies them with coal, and Russian Aluminium, which depends on them for its smelters—have been buying up large swathes of UES shares. They will be the likely winners at any internal auction.

However, minority investors such as Hermitage will still do well, because all this frantic buying has pushed UES's share price up. And Mr Chubais, who is repositioning himself politically, will not only win the gratitude of the oligarchs but also clean up his reputation. Having overseen the scandalous loans-for-shares and voucher schemes in the 1990s, in which state silver was sold to cronies at bargain prices, he is now boasting that he has carried out a privatisation that was fair to all.

Hermitage has, meanwhile, set its sights elsewhere. Next month its research head, Vadim Kleiner, will stand for a seat as a minority shareholder on the board of Gazprom, the state gas monopoly. He hopes to raise questions about dealings that the chairman, Alexei Miller, was appointed to clean up two years ago. These include the use of what look like front companies to distribute gas for Gazprom in nearby countries; puzzling variations in the prices it charges other European gas distributors; a discrepancy between tariff hikes and revenue increases; and suspiciously expensive construction projects. Mr Kleiner is on the board of Sberbank, a state-owned bank that dominates the market, which is suing him for having the temerity to go public with equally awkward questions after the board refused to listen. Nothing, it seems, is sacred any longer.

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Failing executives

Banana-skin leadership

May 29th 2003
From The Economist print edition

Learning from mistakes

“THERE's no success like failure, and...failure's no success at all,” rasped Bob Dylan, enigmatically, in the 1960s. Once, business-book shelves groaned with the works of authors in search of success. The firms to study were those that made shrewd decisions that paid off. Now, many of those books languish unread—not surprisingly, when so many of their heroes are out of a job. The firms to study now, it seems, are the ones that are not shrewd but screwed.

Certainly, failure is more fun to read about than success. Watch the parade of corporate disasters that passes through Sydney Finkelstein's new book, “Why Smart Executives Fail”, and you have a constant sense of *Schadenfreude*. How could Motorola have been so daft as to let Iridium create a $3,000 satellite phone, when ordinary cheap mobile phones were ubiquitous by the time the device went on sale? How could Quaker Oats have lost $1.4 billion buying Snapple, a soft-drinks firm that was losing market share and was overloaded with inventory?

Mr Finkelstein, a professor at Dartmouth's Tuck School of Business, sees common threads in failure. “Truly colossal blunders don't come in isolation,” he avers. “They come in clusters.” Executives lose sight of reality; or they lack the will to change course; or the corporate organisation sets the wrong incentives and prevents important information from getting through. Mr Finkelstein quotes approvingly a specialist in directors' and officers' liability insurance: “The three things behind every bad D&O liability situation are greed, cronyism and denial.” Denial, he argues, is by far the biggest problem.

Donald Sull, an academic at Harvard Business School, has also analysed failure. His new book (“Revival of the Fittest”) argues that good firms go bad when they suffer from “active inertia”. They see market changes coming (Mr Finkelstein's research agrees with that), but respond by doing more of what they have done in the past. Their values become dogmas, and their resources millstones. The danger signs are when a firm's chief executive makes the cover of *Forbes* or writes a book, or when management gurus pronounce your company outstanding.

So is failure escapable? Only with difficulty—if a third new analysis, in the latest issue of the *McKinsey Quarterly*, is correct. Clever people pursue bad strategies, argues Charles Roxburgh, because their brains are wired to do so. Human beings are designed to be overconfident, to be biased in favour of the status quo, and to go with the herd. But the instincts that kept primitive man alive (“If it looks like a wildebeest and everyone else is chasing it, it must be lunch”) are the ones that led Time Warner into its disastrous liaison with AOL and Enron into its suicidal flirtation with electronic markets.

When primitive man chased lunch and found it was a rhino, he learned (if he survived) not to do it again. Nitin Nohria, a Harvard Business School professor whose latest book, “What Really Works”, examines firms that do well and then trip up, thinks that failure is a great teacher. The frequency with which bosses of American firms were fired for bad performance doubled every five years between 1980 and 2000. “We are too ruthless,” he says. “If people are to learn from their mistakes, we need tolerance.” Now there's a big idea.

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About sponsorship

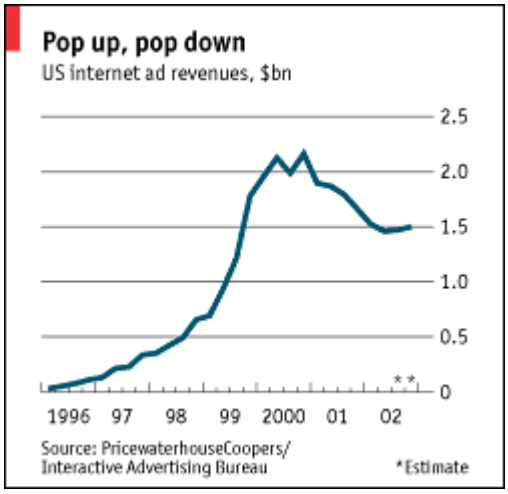
Online advertising

Prime clicking time

May 29th 2003
From The Economist print edition

At last, internet advertising that works but does not annoy

SURFING the web, like the waters, is supposed to be a smooth and speedy experience. But these days, it is more a case of dodging obstacles: advertising windows pop up all over the screen. In reaction, many computer users have installed programs to block the ads. AOL, the leading online service, is distributing software that lets its 35m subscribers suppress pesky pop-ups (except its own, of course).



Fortunately, this irritating online marketing could be the last gasp of a doomed attempt to advertise on the web in basically the same way as print. A less annoying alternative has been found that is more effective than banner ads, which are now mostly ignored by surfers. These are simple, text-based ads that are directly linked to what people are doing online.

This kind of advertising is expected to generate $2 billion this year, almost a quarter of all online advertising sales. Some analysts predict that this will rise to $7 billion by 2007. A race for dominance in this promising market is already under way between Google, a popular web-search service, and Overture, another search firm.

Search firms pioneered the new form of advertising, variously known as “search-related” or “pay-per-performance”. The idea is to use search terms as a proxy for a surfer's consumption interests—and dish up text-based commercial listings related to the search terms, along with the search results. In most cases, these are separate lists along the right side of the screen, with the ads labelled as such.

Advertisers pay only if people actually click on such “sponsored” links. How much they pay per click, at least in the basic version of the ad programs, depends on how high firms want their listings to rank and how popular is their associated search term (or “keyword”). These are auctioned off, with the top spots going to the highest bidders. To be the first sponsored link in America when somebody searches for “The Economist”, say, an advertiser must bid around $2.50 per click. “Journalism” costs only 30 cents.

Overture invented the concept, which was initially derided as another bizarre dotcom business model that would never take off. But the firm, which went public in June 1999 as GoTo.com, made it work by syndicating its ads to popular websites, such as Yahoo! and MSN, and sharing the revenues. It is now a fast-growing, profitable internet start-up. Last month, it reported first-quarter revenues of $225m—up by 57% from the same period last year.

The main reason for this unexpected triumph was the end of the internet boom, according to Gary Stein, an analyst with Jupiter Research, a market-research firm. With capital no longer free, advertisers were no longer willing to waste their money on often-ignored banner ads and were looking instead for more efficient forms of advertisement. Yet consumers also like the new ads: they are not intrusive and, even better, they are often relevant.

How they are made relevant is the main difference between Overture and Google, which introduced its own pay-per-performance program early last year. Overture ranks ads according to how much advertisers bid. Google also ranks ads by how popular they are, measured by the click-through rate. This pushes advertisers to make their links more relevant.

Google, which is being sued by Overture for patent infringement, has also innovated in the way it auctions keywords—although Overture now offers this format as well. The highest bidders still get the top spots, but only pay the amount offered by the next-highest bidder, plus one cent. This is meant to encourage advertisers to bid the highest amount they are willing to pay, without having to second-guess what the next best bid will be.

Google, which may go public late this year or early next, claims it is now ahead of its rival, with 100,000 advertisers to Overture's 88,000. Overture's shares have tumbled since Google entered the fray, from more than $42 to $15, although they have recovered a bit recently.

The critical battle between the two firms will probably be over “content-targeted” advertising—which links ads not to selected keywords, but to the content of web pages. This is done by using software to boil text down to a handful of keywords and to serve up related ads next to it. Just as with search-based advertising, the idea is that surfers are more likely to click on ads relevant to a web page's content than on a scattershot banner ad.

This time, Google was first. Since March, its ads have also been appearing on the pages of such websites as HowStuffWorks.com and Slashdot.org. Content targeting also explains why the firm recently acquired two start-ups, Applied Semantics and Pyra Labs. The first is a developer of content-targeting software; the second sells software to create personal web pages called “web logs”, or “blogs”, which could make excellent homes for Google's ads.

Overture appears to have expected such moves. Earlier this year, it bought AltaVista, a rival to Google, and the search division of FAST, a Norwegian firm. These acquisitions should help it to be more like its rival: it can now also offer high-end search services to its partner sites. Later this year, the firm will also start offering content-targeted advertising.

There is more to come. Expect both firms to use the huge amounts of data gathered through their search services to make their ads even more relevant to surfers. In a way, says Hal Varian, an economist at the University of California at Berkeley, who helped Google to set up its advertising auctions, marketing is at the same turning-point as financial services were 30 years ago: at last, the data is available to put all the fancy theories into practice. Long live the internet advertising dream.

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Face value

A star falls?

May 29th 2003
From The Economist print edition

Robin Saunders, a case-study in the dangers of burning brightly

Financial Times

ONCE queen of the City of London, or princess at least, Robin Saunders, American, blonde, mother of twins and über deal-maker, has been having what the real queen might call an *annus horribilis*. Earlier this month her employer, WestLB, a regional state-owned German bank, sharply increased its bad-debt provisions to *euro*1.9 billion ($2.2 billion), thanks not least to a *euro*400m rise in provisions at the unit run by Ms Saunders. This was largely to cover potential losses on a deal for Box Clever (no comment necessary), a television-rental firm that Ms Saunders was responsible for buying. Regulators are sniffing around. WestLB is investigating the risks of this and other deals that Ms Saunders' unit has on its books. The press has its knives out for a woman whom it once thought could do no wrong.

A graduate of Florida State University, Ms Saunders came to the City in the early 1990s. In 1998 she was poached by WestLB from Deutsche, a big German bank, along with her team. Since then, she has had an unusually high profile, and not only for her fabled looks—though the press has not been averse to those, in an industry famously dominated by ugly men in suits. Ms Saunders is a dealmaker specialising in "principal finance". The language of this business is arcane, but in essence it involves a bank using lots of debt, which it supplies itself, to buy companies, and then parcelling the debt up into securities of differing risks and (sometimes) selling these on to investors with different risk appetites. The cashflows from the business are meant to pay the interest. The key, of course, is to buy only firms with stable enough cashflows to service the debt. Box Clever did not fit the bill. Whether it appeared to when it was bought is a question that German regulators are presumably probing.

How many other deals fit the bill is equally unclear. Ms Saunders has pulled off many a deal termed "risky" by competitors, but it was sometimes others that took the most risk. Her group was responsible for arranging the deal that enabled Philip Green, an acquisitive retailer, to buy BHS, a department-store chain, although the two later failed to buy Marks & Spencer, another retailer also down on its luck. Ms Saunders sits on the BHS board and receives handsome dividends. Ms Saunders was also responsible for raising the funds needed to rescue Formula One's $1.4 billion bond issue in 1998. Her employers are still saddled with perhaps $700m of the bonds. She also put together a deal to fund the redevelopment of London's Wembley Stadium.

It is the firms in which WestLB retains sizeable stakes that are attracting the greatest scrutiny. It owns around one-fifth of Pubmaster, a pub chain, and most of Kyndal International, a spirits chain. The debt for the latter still sits on its books; the latest shenanigans mean it is likely to stay there. In March, WestLB also bought Odeon cinemas for a princely £431m ($682m), most of which also languishes on the German bank's balance sheet.

Attention has now turned to apparent conflicts of interest of Ms Saunders and some of her colleagues, who have personal equity stakes worth millions in firms to which their bank lends, such as Mid-Kent Water and Kyndal. These stakes typically cost their owners little more than loose change. Lenders, be it noted, have quite different interests in how a company is run than equity investors, since they have little of the upside gain. The bank insists that there has been no wrongdoing.

Beyond that, quite what Ms Saunders's employers think about all this is hard to say. Jürgen Sengera, WestLB's chairman, has been lukewarm in his support for her. "I think we should be fair to all and wait

for the result of the investigation and then we will make a statement," he said a couple of weeks ago. But the bank's owner, the state of North-Rhine Westphalia, is getting increasingly shirty about how the bank is run. In mid-May it put Jochen Dieckmann, the state's finance minister, on the bank's supervisory board.

Such attention is well overdue, though whether the worthy Mr Dieckmann is the man for the job is debatable. WestLB has long been a byword in financial circles for its aggressive lending, much of which has soured. It lent extravagantly in South Korea and Mexico before their crises hit in the mid-1990s, taking advantage of its state guarantee to undercut the competition. It also lent heavily to Enron and WorldCom. The European Commission has now ruled that "taking advantage" of such guarantees is illegal: the German government will phase them out by 2005.

The trouble with stars

In essence, WestLB has been a second-tier bank in an overbanked market, desperately seeking profits, whatever the source and whether or not it understood how they arose. The bank's specialised-finance department, of which principal finance is a big part, contributed half its profits during the past four years. The bank seems to have had little grasp of what it was getting into, nor wanted to look too closely. In that, it fits a familiar pattern, which in a more extreme form contributed to such disasters as the fall of Barings at the hands of a superstar who generated huge paper profits from an activity—supposedly arbitrage—that the bank did not understand. In a similar vein, did Nomura, a once-mighty Japanese securities house, understand the risks run by Guy Hands, head of its principal-finance operation until he left to set up his own outfit, where he still manages some of its positions? Recent heavy losses on Le Méridien Hotels suggest not. And might CSFB have avoided such heavy fines and regulatory wrath had it resisted the pressure from its technology-banking superstar, Frank Quattrone, to let him, in effect, run a bank within a bank, complete with its own settlement and legal staff?

The Saunders affair, then, is but another example of a bank failing to ask tough questions, perhaps for fear that a superstar might walk off. The lesson, yet again, is that the emergence of a superstar is a good reason to ask tougher questions than ever.

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American foreign aid

Bush, hero or hypocrite?

May 29th 2003 | WASHINGTON, DC
From The Economist print edition

AP

George Bush is blasting Europe's aid policies, while touting America's

AMERICA is the world's stingiest donor of foreign aid, in relation to the size of its economy. Yet George Bush has left no doubt that he will use this weekend's G8 summit in Evian, France, to show American leadership in development policy—and to dare the Europeans to do better.

On May 21st, Mr Bush threw down the gauntlet. America, he argued, was at war with enemies of “plague and starvation and hopeless poverty”, just as it was at war with terrorists and tyrants. He pointed to a new $15 billion American pledge to combat AIDS, the biggest-ever single government commitment to fight a specific disease. And he touted the “Millennium Challenge Accounts”, a new mechanism for giving money to well-governed poor countries that he dubbed “an entirely new approach to development aid”. Right on cue, Bob Geldof, popsinger-turned-activist, this week shocked readers of Britain's *Guardian* newspaper by saying that the Bush administration had the most positive approach to Africa since the Kennedy administration in the 1960s.

Mr Bush lambasted the Europeans for their “unfounded, unscientific fears” of genetically modified (GM) crops, which were hindering the battle against hunger, and for their profligate use of export subsidies. But in their approach to foreign aid, too, they needed to move “beyond the broken development policies of the past”, he said. Can the tough military-minded Bush team truly claim leadership on such a soggy issue as development policy?

On trade, at least, many of Mr Bush's accusations ring true. The European Union (EU) moratorium on approving GM crops has certainly had tangible consequences in poor countries. Witness the sub-Saharan countries that rejected American food aid, despite widespread hunger, for fear that they would jeopardise their exports to Europe. However, Mr Bush overstates his case. Research into GM technology is a long way from producing miracle crops to ease global hunger. Nor is it clear that such strident American criticism will prod Europe into changing its policies: the backlash could actually make it harder for the EU to lift the GM moratorium.

Yet on export subsidies Mr Bush has a point. The EU is the world's most profligate wielder of such subsidies. They are a particularly pernicious form of agricultural support, as even the French now

acknowledge. As part of his Evian agenda, Jacques Chirac, the French president, has proposed a moratorium on export subsidies to Africa. Why just Africa?, asks Washington. Why not eliminate export subsidies outright, which is ostensibly the goal of current Doha development round of global trade talks?

America clearly trounces Europe in the ambition it holds for this trade round. The administration's proposals are bold, not just on export subsidies, but on domestic farm support and agricultural-tariff cuts. Unfortunately, when it comes to action, America is not so squeaky clean itself. Not only did its farm bill last year dramatically increase support for farmers; its pampering of certain groups (such as cotton farmers) specifically hurts poor countries. Much of its largesse has a self-serving side: according to the Europeans, America's huge food-aid programme is itself a thinly disguised export subsidy.

Big on AIDS

On aid, Mr Bush's harrying of the Europeans smacks of hubris. Not only is America relatively stingy with foreign aid; the quality of its assistance is also poor. A lot of the aid is "tied" to the purchase of American goods and services. And much aid is disbursed for strategic rather than developmental ends—helping Egypt and Israel, in particular. Even by the low standards of aid bureaucracies, America's main one, USAID, is inefficient and ineffective.

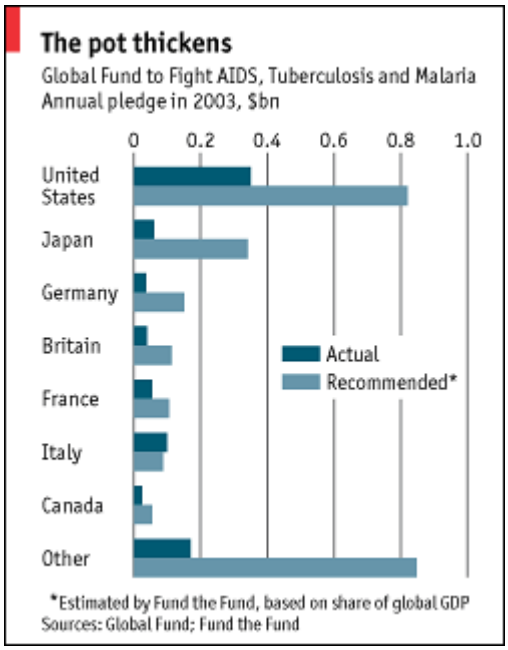
From this low starting-point, however, Mr Bush is spearheading what could be a big rethink in American aid policy. His is the first administration in decades to propose big increases in foreign assistance. He has pushed bold initiatives remarkably quickly. And his team seems determined to make aid more effective.

The $15 billion AIDS initiative, which Mr Bush first touted in his January state-of-the-union speech and signed into law on May 27th, is remarkable both for its size and for the speed with which it became law. If fully funded (which remains a big if) the plan would triple America's spending on AIDS over five years. According to the White House, it would help to prevent 7m new HIV infections, treat at least 2m people with life-extending drugs and provide care for 10m HIV-infected individuals and AIDS orphans in 12 countries.

Although it is true that one-third of the money earmarked for prevention has to be spent on promoting sexual abstinence (a conservative favourite viewed with scepticism by many public-health officials), the overall strategy is to mimic Uganda's successful method, which focuses on abstinence, fidelity and using condoms. Mr Bush successfully stopped conservative ideologues from hijacking the AIDS plan.

That said, most of the money will be spent on untested new programmes. Only a small share (theoretically up to $1 billion a year, but probably much less) is to go to the Global Fund to fight AIDS, Tuberculosis and Malaria, a multilateral fund set up last year with the G8's blessing. Even that contribution is dependent on being matched two-to-one by other countries. One of Mr Bush's goals at Evian will be to shame these countries into ponying up.

Despite helping to create the Global Fund, several countries have been remarkably mean. Japan, for instance, has pledged only $60m this year and Canada only $25m (see chart).



Until now, the Global Fund has approved roughly $1.5 billion to finance 153 programmes in 92 countries, from anti-retroviral treatment in Honduras to condoms in Laos. In order to support the latest round of proposals from applicant countries, it reckons it needs more than $1 billion by October. And so far, only $485m has been pledged for next year.

Given the existence—and cash needs—of the Global Fund, Mr Bush's decision to spend billions more on a new bilateral initiative may not be the most efficient use of resources. But there are signs that his tactics are already working on the Europeans. Mr Chirac admitted this week to the *Financial Times* that "the Bush administration has taken a very positive step increasing the amount of money devoted to the fight against AIDS: this obliges us in Europe to follow suit".

Elsewhere, the revolution in American aid policy is less advanced.

The Millennium Challenge Accounts are meant to double America's spending on development aid over three years, focusing on a few good performers. Great idea, but unfortunately little has happened. The Bush team has developed some (broadly sensible) ideas on the selection of countries; but, as yet, there is no money and no organisation. Worryingly, the recent budget asked for only 40% as much money for the plan as Mr Bush had originally touted. Until the accounts are up and running, Mr Bush's claims to superiority in aid policy will sound premature.

Yet his attitude is surely good for the world's poor. They should be the beneficiaries of competition among rich countries to show who does most on aid and trade. If it prods the Europeans and others into action, a bit of Texan swagger at Evian will be no bad thing.

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Auditors

Revenge of the nerds

May 29th 2003
From The Economist print edition

Auditors trying to limit their liability begin to vote with their feet

WITH some temerity—considering the bad odour that auditors are in these days—accounting firms have started a campaign to have their liability for bad work capped in court. The alternative, say top partners at the big firms, is that they will have to stop auditing many of the world's top companies.

Auditors are frequently sued for billions of dollars for failing to spot lies in company accounts. Many have already changed into limited-liability partnerships as partial protection. But now they want a cap on the liability that falls on the firms' own assets. They argue that lawyers go after them because they have plenty of money, and that they pay amounts disproportionate to their sins—the pockets of the companies whose senior executives did the lying are not as deep. Following the demise in 2002 of Arthur Andersen, the world's fifth-largest accounting firm, the profession fears that another of the four remaining big firms—PricewaterhouseCoopers (PWC), KPMG, Ernst & Young and Deloitte & Touche—could be sued out of existence.

Insurance firms are either refusing to cover auditors for much, or are charging prohibitively expensive premiums. Some commentators estimate that the profession is paying out $2 billion a year in settlements, according to Neil Lerner, head of risk at KPMG in London—about 8% of their collective audit revenues for 2002.

Already, with no cap on its liability, PWC is dumping dozens of clients in Britain. In some cases this is because it thinks their management may be dishonest. In others, PWC has decided that a company's business is too complex or ephemeral: banks, with their big derivatives books, are a particular bugbear, as are insurance companies. “Why the hell would anyone want to audit a big financial institution?” asks an auditor at one of the big four, given that the majority of big claims against auditors have concerned financial firms. Companies in the volatile construction business and those on the leading edge of technology might also face higher audit fees or no audits at all, says another big-four partner.

Two years ago an official review of English company law concluded that auditors should be able to limit their liability. If Britain leads the way, reckons the Institute of Chartered Accountants in England and Wales, a trade body, other countries may follow. Indeed, the Australian government said last year that it would replace the principle of joint and several liability for auditors with that of proportionate liability, and also allow auditors to incorporate.

But it is in America that the big four are most vulnerable. There is no sign that the American government will put a cap on auditors' liability, but the profession will soon start lobbying for one. Not only are shareholders there highly litigious, but auditing is poor. Auditors in America are paying out more in settlements than ever before; but they have managed to reduce their legal exposure, says John Coffee, a law professor at Columbia University.

In 1994 the Supreme Court ruled that aiding and abetting a securities law violation was no reason to sue an auditor. In 1995 the Private Securities Litigation Reform Act substituted proportionate liability for joint and several liability as the standard for damages. Because auditors felt safer after these changes, says Mr Coffee, companies got away with more aggressive accounting in the late 1990s. Straight after the 1995 act, audit firms started doing less work, says Lynn Turner, formerly with the Securities and Exchange Commission but now at Colorado State University. They decided, for instance, to test a portion of a company's internal controls each year, not all of them. Neither Mr Turner nor Mr Coffee oppose a cap on auditors' liability, however. Liability is there to deter acquiescence by auditors, says Mr Coffee, not to create a fund to compensate investors.

The best cap on auditors' liability would be one linked to the size of each client. A limit of ten to fifteen times the total fees from a company—for audit and non-audit services—should ensure that bad auditing is punished but that firms do not pay out disproportionate sums. Shareholders should get something in return. The threshold for convicting an auditor in a lawsuit in America, says Mr Coffee, should be lowered: it should be enough to prove negligence rather than direct participation and intent to deceive. A cap on liability should not, however, discourage auditors from dumping risky clients, which is a better incentive for good behaviour all round. The priority for audit firms should be to assess the legwork and risk involved in auditing each client—and to charge the difficult ones a hefty premium.

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Japan's auditors

A slight Resonance

May 29th 2003 | TOKYO
From The Economist print edition

Japanese auditors may be getting tougher

Get article background

AFTER an earthquake north-east of Tokyo on May 26th, officials took close readings of the more than 200 aftershocks that followed. The potential after-effects of the recent quake among Japan's auditors, meanwhile, are harder to gauge. Some politicians are furious that Shin Nihon, an accounting firm, played a crucial role in driving Resona Bank to seek a government bail-out two weeks ago. Surprisingly, in a culture where auditors have little or no power to challenge senior management, Shin Nihon refused to accept the bank's estimate of how many deferred tax assets it could count as capital.

One reason that America's spate of accounting scandals has made such an impact is that published financial statements matter there. American investors may have fooled themselves for years, but when the accounting scandals erupted they remembered how much genuine profits counted—and reform quickly followed. Japan's bubble, by contrast, burst over a decade ago. The trouble is not that investors have bad numbers to work with, but that they have few good companies to choose from; and they have few powers to whip bad companies into shape.

The fates of failed companies depend on political decisions, rather than market ones, and they are mediated through regulators, bankers and politicians from the ruling Liberal Democratic Party. The accounting issue that caused Resona Bank trouble—future tax credits that held little real value because the bank was so unprofitable—was seized upon by a regulatory faction that wanted to be tougher on banks. It was only because it found itself outgunned politically that it left the auditors to make the hard decision.

The good news is that Japan's four big audit firms seem to be standing up for themselves. Shin Nihon got stuck with the Resona dirty work only after another auditor, Asahi & Company, had refused to sign off the accounts. Some non-financial companies have had to restate some of their numbers; new rules on auditor independence should accelerate this trend. Unless all this leads to truly radical change in the banking sector, however, investors will still have to deal with dire numbers, even if they become a bit more reliable.

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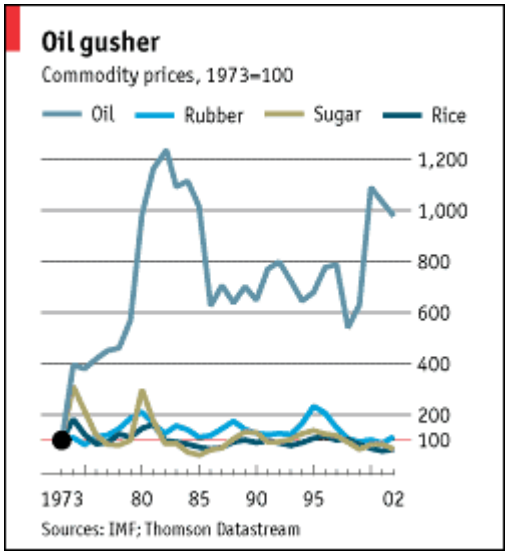
Commodities

Rubber barons?

May 29th 2003 | BANGKOK
From The Economist print edition

Attempts to control world rubber, rice and sugar markets will not succeed



IF OPEC, the oil producers' cartel, could in its heyday triple the price of oil overnight, why can't producers of other commodities club together to strike it rich? Thus runs the logic of Thaksin Shinawatra, prime minister of Thailand and an eager creator of cartels. In the next few weeks he hopes to bring together representatives of the world's five main sugar exporters to discuss ways to limit supply and boost prices. Last October he convened a similar meeting of rice-exporting countries. And last August Thailand, Malaysia and Indonesia set up a fund to increase the price of rubber by manipulating supply. Should the world be bracing for sugar, rice and rubber shocks to match the oil shocks of the 1970s?

At first glance, Mr Thaksin and his friends look powerful enough to bring consumers to their knees. The countries invited to this month's meeting represent two-thirds of the international trade in sugar. Those that attended the pow-wow in October account for roughly three-quarters of global rice exports. And the three members of the International Rubber Company, plus Vietnam, which wants to join, produce 77% of the world's supply of natural rubber. In the nine months since they got together, the price of rubber has risen by over 20%.

But there is no need for panic-buying just yet. The members of the nascent rubber cartel, like their counterparts in OPEC, are already having trouble sticking to their quotas. In August, they agreed to cut output by 4%. But faced with burgeoning sales of tyres in China, officials in both Thailand and Indonesia changed their tune. Production, they said, should grow, not shrink.

Furthermore, demand for natural rubber is, appropriately enough, quite elastic: it depends on the relative price of synthetic rubber. As it is, in 2002, consumption of synthetic rubber increased faster than that of the natural kind. If the price of oil, the main ingredient of synthetic rubber, continues to fall, that trend will only get sharper.

Supply is fairly flexible too. Although rubber trees must grow for several years before they yield much sap, enterprising farmers in other countries would doubtless start planting if the price rose sufficiently high, just as big oil firms embark on exploration and development of new fields when the oil price goes up.

High rice or sugar prices would trigger an even faster supply response. Although the putative cartels dominate international trade in both commodities, they do not come even close to dominating global output, since most of the world's rice and sugar is consumed in the countries where it is produced. International trade in rice, for example, involves less than 7% of total world production. Should the price of rice rise significantly, some of the other 93% would presumably soon find its way to the market. And rice farmers, unlike oil producers, cannot stockpile output for long when the price falls, since their product is perishable.

Then there are the logistical problems. In Thailand, rubber, rice and sugar are traded by millions of farmers and middlemen, rather than by one state-owned giant. The government interferes in the market through various state-owned trading agencies and price-support schemes. But these have generally lost money and attracted accusations of corruption. Any grander effort to control the trade in these

commodities would only increase the opportunities for misbehaviour—and the cost to Thai taxpayers.

No wonder many observers doubt if Mr Thaksin's cartels will ever get off the ground, let alone achieve much should they do so. The more schemes he proposes, the greater the scepticism. Time, perhaps, to rein in supply.

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About sponsorship

Northwestern Mutual

Under attack

May 29th 2003 | NEW YORK
From The Economist print edition

Companies have a new form of analyst to reckon with

NORTHWESTERN MUTUAL has an enviable reputation for selling life insurance to the rich, and also a top-flight rating for claims-paying ability from all three of the big rating agencies, A.M. Best, Standard & Poor's and Moody's. A fourth, smaller rating agency, Weiss, ranks it one step down from the top, but that still means “excellent” and puts Northwestern among the top 14 of 1,100 companies. Northwestern's annual report is light on financial information but it suggests that the company has both consistent revenues and decent investment returns.

This, according to Richard Johns, is a mirage. Mr Johns, a present and former policyholder, runs a small organisation, Policyowner Protection Services, that is devoted to scrutinising one company: Northwestern Mutual. The bulk of its efforts appear on a website (www.nmlcomplaints.com) and can be split into four rough categories: management is rotten; the company's financial condition is becoming rotten; its insurance products will leave customers feeling rotten; and finally, top agents are heading for the door, either because their activities have triggered probes, or because they could no longer bear the rotten culture.

Harsh stuff—and it has not gone unnoticed. Moody's and Standard & Poor's both say they have had conversations with Northwestern about the allegations and concluded there was no cause to adjust their ratings. Joe Belth, author of an insurance newsletter in Indiana, has found that some of the letters on the site are written under pseudonyms (Mr Johns says they were agents or former agents under cover). Other entries were taken out of context. Information on the site, he says, should not be taken seriously.

Yet can it also be ignored? Mr Johns and his sources are hard to dismiss entirely. The website alleges that Northwestern is under investigation by the National Association of Securities Dealers (NASD) for inappropriate sales tactics. Northwestern acknowledges it is being looked at by the NASD, but claims this is only because there is an industry-wide investigation into one of its products, variable whole life insurance. There is a second issue over the late reporting of customer complaints, which may result in a small fine, it adds.

One could argue that the consumer of any insurance product would be better-educated after wading through Mr Johns's site. Mr Johns was an early critic of variable whole life, a popular hybrid of a mutual fund and insurance. A related product, the variable annuity, was cited by the NASD this week when announcing the censure of one firm and civil charges against people at three others (none of them at Northwestern).

Over the past decade, Northwestern's record has stood up well within the life-insurance industry, but it has not been beyond reproach. The nmlcomplaints.com site has a vast library of litigation, as well as a note that Northwestern agents will pay an additional 11% this year for errors and omissions insurance, because of the cost of settling several large claims (Northwestern says the real number is 9%, including the cost of successful defences). Mr Johns's own crusade began five years ago when, he contends, he received a poor settlement for a mis-sold product.

Northwestern contends that the site is a hunting-ground for lawyers seeking clients. Its response, says Mr Belth, has been not to call attention to it. Why does the company not respond or sue? Northwestern says there are huge obstacles to effective use of the law to stop commentary on the internet. No doubt competitors are watching closely. In today's world of angry customers and growing scrutiny what company does not face a similar risk?

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Morgan Stanley and LVMH

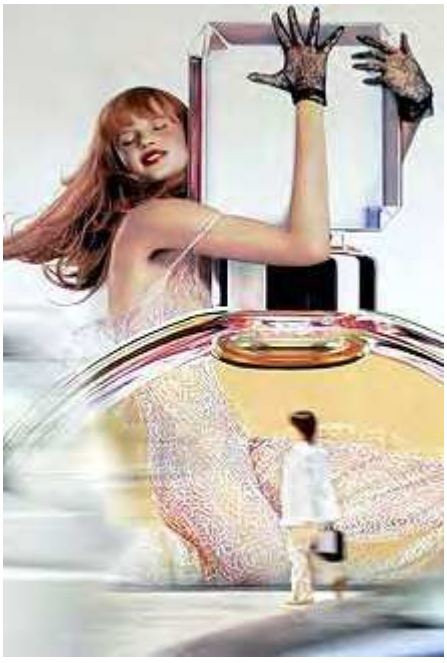
A slap on the chic

May 29th 2003
From The Economist print edition

Did Morgan Stanley systematically denigrate LVMH?

Get article background

AFP



Luxury-goods analysis

MORGAN STANLEY has proved good at avoiding bad publicity as corporate and financial scandals have unfolded. The American investment bank did not advise Enron, WorldCom, Tyco, Adelphia, Qwest, or many other badly tainted firms. Mary Meeker, Morgan Stanley's "star" internet analyst, was spared the public pillorying inflicted on Henry Blodget, once an internet guru at Merrill Lynch, or Jack Grubman, a former telecoms analyst at Salomon Smith Barney. And the bank's fine by American regulators, along with other banks, for letting investment bankers influence equity research, was one of the lowest on Wall Street.

Yet Morgan Stanley was not allowed to feel smug, even for a moment. A remark by Philip Purcell, its chief executive, that the firm had emerged "relatively unscathed" from the settlement and had not damaged its relationship with investors brought a thunderous rebuke from William Donaldson, chairman of the Securities and Exchange Commission. Mr Purcell had shown a "troubling lack of contrition", Mr Donaldson said in a public letter. Now Morgan Stanley has filed a counter-lawsuit in a Paris court against LVMH, a French luxury-goods conglomerate: does it have merit—or does it show a further troubling lack of contrition?

Morgan Stanley this week sought damages of *euro*10m ($11.7m) and the publication of a judgment (if in Morgan Stanley's favour) in 20 newspapers and magazines, in a legal battle over biased stock research. LVMH had issued writs against Morgan Stanley both last October and in February this year seeking *euro*100m for the alleged damage Morgan Stanley did through its "unfair" reports on LVMH.

The LVMH litigation is a first in Europe. The company claims that, between 1999 and 2002, Morgan Stanley was deliberately and systematically unfair to LVMH in its stock research. The reason, it says, is that Gucci, another luxury-goods firm, was one of Morgan's best investment-banking clients: making LVMH look bad was good for Gucci. Morgan Stanley helped to take Gucci public in 1995 and then helped it to fend off a takeover bid by LVMH in 1999. The bank brought in as a "white knight" François Pinault, head of Pinault-Printemps-Redoute (PPR), another French conglomerate, and arch-rival of Bernard Arnault, boss of LVMH. Mr Pinault bought 42% of Gucci. Two years later LVMH sold its remaining stake in Gucci.

Yet the battle over Gucci was not the end of the feud between the two French barons. Five journalists have resigned at *La Tribune*, a financial newspaper owned by LVMH, in protest at the paper's biased coverage of PPR. One of LVMH's allegations, on the other hand, is that in an interview with *Corriere della Sera*, an Italian newspaper, in April 2001, Claire Kent, Morgan Stanley's luxury-goods analyst, tried to blacken the firm's reputation so as to enhance the image of Gucci. LVMH doctored quotes from the article to prove its case, counters Morgan Stanley.

Another accusation is that Morgan Stanley alluded in a "fanciful" way to a possible deterioration of LVMH's credit rating. That was merely a reaction to a negative outlook published by Standard & Poor's, a rating agency, says Morgan Stanley. Morgan is also accused of speculating about the impact of a weak

yen on LVMH's profits, of suggesting that Donna Karan, a clothes retailer, integrated badly into LVMH, and of producing an indulgent report on Gucci results in September 2002. Morgan claims that it was right about the impact of the yen on LVMH, as well as problems with integrating Donna Karan, and also says it was not too nice to Gucci. All its comments on LVMH in the four contentious years were justified, it maintains.

This battle, pitting wounded Gallic pride against American self-assurance, will drag on until at least the end of the year. Few would be surprised to see Messrs Arnault and Pinault suing each other before the end of the case. They have made a habit of taking each other to court in recent years. In the meantime Morgan Stanley must balance fighting its corner with being contrite elsewhere.

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Finance in Kazakhstan

Small but elegant

May 29th 2003 | ALMATY
From The Economist print edition

A model sector that wants to grow

Get article background

THE Kazakh financial system was less damaged than those of other central Asian countries by Russia's debt crisis in 1998. Kazakh banking assets have quadrupled since then to nearly $9 billion, while the 230 banks that existed in 1993 have consolidated to 38. The three largest hold 60% of the country's banking assets.

The financial sector is small for a land of 2.7m square kilometres with a GDP (mostly from oil) of $24 billion. But thanks to determined regulation, and a mimicking of western financial products, it is growing. In 1999, household deposits in banks were a meagre $311m, while $1.2 billion was held in cash, mostly dollars. Today, Kazakhstanis have over $1.8 billion in their bank accounts.

Inspired by Chile's pension reform, Kazakhstan has been moving since 1998 from a pay-as-you-go to a funded system, helped by mandatory contributions of 10% of salary. Today, 5.5m Kazakhstanis—over 70% of the workforce—contribute to pension funds, which have accumulated $2 billion. There is a third tier of voluntary contributions, but this has attracted only 35,000 accounts. The pension funds have in turn supported the development of new financial instruments. In the early days, they invested heavily in short-term treasury paper, but today government securities make up less than half of pension assets. Corporate bonds appeared in 2000, and over $730m have been issued since then—without a single default—at an average maturity of five years.

Mortgages were introduced in 2001 and total $130m. The central bank expects volume to double this year. Billboards advertising mortgages adorn the streets of Almaty. Interest rates, now at 15%, have been falling. “Each time rates go down, more borrowers come out of the woodwork,” says David Lucterhand of Pragma Corporation, a consulting firm funded by USAID working with the central bank. Last November, the Kazakhstan Mortgage Company was the first in the Commonwealth of Independent States (CIS) to issue a mortgage-backed bond; securitised car loans and credit cards should soon follow.

Financial standards and regulation are claimed to be up with international practices in most areas. In 2001, Grigori Marchenko, the central-bank governor, fought hard to introduce consolidated financial supervision, which will be devolved next year to a separate agency. An electronic payment system is up and running. An actuarial training centre has been set up; a body of professional mortgage practitioners has been developed; and a central consumer credit database—another first in the CIS—is being created.

Yet the overall market is small and heavily concentrated in Almaty. In relation to the country's GDP, bank deposits total only 16%. Most loans and deposits are still in dollars. Mr Marchenko believes that the tide is turning as the local currency (the tenge) appreciates against the dollar and pays higher interest rates. The recent fast growth in credit also raises some questions about the quality of loans. And Mr Marchenko singles out the deposit-insurance system, introduced only in 2000, as ripe for further improvement.

Equity trading on the electronic stock exchange has been slow to pick up. This limits the options for pension funds, which are sitting on cash—although they have so far shown little appetite for more volatile instruments. According to Mr Marchenko, most listed companies are owned by strategic investors who do not wish to sell. In future, A-listed companies may be required to keep 25% of their capital as a free float. Selling off remaining state companies would help, say observers.

True beneficial ownership and control of financial institutions in Kazakhstan, as in much of the CIS, remains somewhat murky. Minority-shareholders' rights are often flouted. But the biggest barrier to an

effective financial market may be demography. Since independence in 1991, people have been leaving the country, while mortality remains relatively high and birth rates low. The potential market for financial services is therefore shrinking. Low incomes keep down contributions to pension funds and life-insurance policies. Such financial services, for most Kazakhstanis, remain a bit of a luxury.

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Economics focus

Freeing the airwaves

May 29th 2003
From The Economist print edition

Should radio spectrum be treated as property, or as a common resource?

WHAT is the best analogy for radio spectrum? Is it, as most people intuitively believe, a palpable resource like land, best allocated through property rights that can be bought and sold? Or is it, thanks to technological progress, more like the sea, so vast that it doesn't need to be parcelled out (at least for shipping traffic), in which case general rules on how boats should behave are enough to ensure that it is used efficiently.

Wireless folk have been discussing these questions for some time. Now, regulators are starting to take an interest, because increasing demands for wireless services require more efficient use of the spectrum. Earlier this month, America's Federal Communications Commission (FCC) decided to allow leasing and trading of frequency licences—the property model—as a first step towards establishing a market in radio spectrum. However, when regulators meet for the World Radiocommunication Conference in Geneva, starting on June 9th, they will try to harmonise their plans to expand the part of the spectrum that can be used without a licence, treating it as a common resource.

These two different regulatory models are already competing across the airwaves. On the one hand, telecoms companies have spent vast sums on licences for third-generation (3G) wireless services—but are facing serious financial and technical obstacles to building networks. On the other, there are already many wireless local access networks, called WiFi, which operate in unlicensed spectrum—and are growing at a phenomenal rate.

The question of how best to allocate spectrum is not new. Over 40 years ago Ronald Coase, who won the Nobel prize for economics in 1991, argued that there is no reason why spectrum should be treated differently from, for example, land. Both are scarce—so a market is the best way to allocate their use. Although this seems blindingly obvious today, it took the FCC more than two decades to start auctioning radio frequencies.

The debate has since moved on. Auctions alone are now considered unsatisfactory, because they do not change the traditional structure of spectrum allocation. And even after last month's reforms allowing leasing and trading, the FCC remains a *dirigiste* bureaucracy which decides, in most cases, how the spectrum is divvied up, who gets which slice, and for what use.

So what is the best way to replace this command-and-control regime? Proponents of the property approach want to create, as soon as possible, a market in which rights to spectrum blocks can be freely traded—rather in the way that pollution rights now are. Some have already drawn up plans for a “big bang”: a giant simultaneous auction of as much spectrum as possible.

Hold hard, say the advocates of common access. If spectrum were scarce by some law of nature, they argue, selling licences would certainly be the best solution. But in fact it is scarce only in terms of old, clunky technology. When radio equipment needed “channels”, defined by frequency and power, to allow communication without interference, airwaves were indeed a scarce resource.

Now, however, thanks to the dramatic decline in the cost of computer power, wireless devices are far cleverer, meaning that they can use spectrum more efficiently and are more tolerant of interference. They are able to communicate over a broad range of frequencies at once (this is called “spread spectrum”), to help each other out (“mesh networks”) and to adapt to the local environment (“agile radio”). Instead of creating a spectrum market, argues Yochai Benkler, a law professor at New York University, it should now be possible to rely on the market in smart radio equipment without anybody having to control the airwaves.

Technological progress is not the only reason why spectrum markets would be a second-best solution, Mr Benkler argues. For one, they are likely to come with high transaction costs. If spectrum is priced efficiently in an increasingly dynamic wireless world, the necessary overhead in network management and metering is likely to be quite costly. Innovation could suffer as well: rights holders could ignore technological improvement just because it does not fit their business model. With spectrum as commons, anybody can innovate, as users do on the internet.

Keeping the options open

Despite their differences, the two camps agree that they do not have enough hard data to bet everything on one regime: they must experiment with both. David Farber and Gerald Fulhaber, telecoms professors at the University of Pennsylvania, for instance, want a big-bang auction. But they also want to let others use spectrum freely, as long as they do not “meaningfully” interfere with the owner's right to a clear broadcast.

Despite its recent move toward a spectrum market, the FCC too prefers a hybrid approach, saying in a recent report that “no single regulatory model should be applied to all spectrum”. Early last year, it authorised systems using a technology called ultra-wideband to operate at very low power to avoid interference. The agency is also looking into expanding the part of the spectrum for which no licence is needed.

If experiences in other areas of technology are any guide, there is a good chance that both approaches will be around for some time, although the commons solution may eventually come to dominate. The internet, at least from the perspective of the end-user, is a common resource, with bandwidth allocated on a first-come-first-served basis. In software, the commons is growing, in the form of free open-source programs developed by volunteers.

Technology may thus help to create markets; but it also makes some of them obsolete. In this case it has turned land into sea, metaphorically speaking. To draw a historical parallel: the development of better ships did not lead to parcelling up the world's oceans but to something called free trade.

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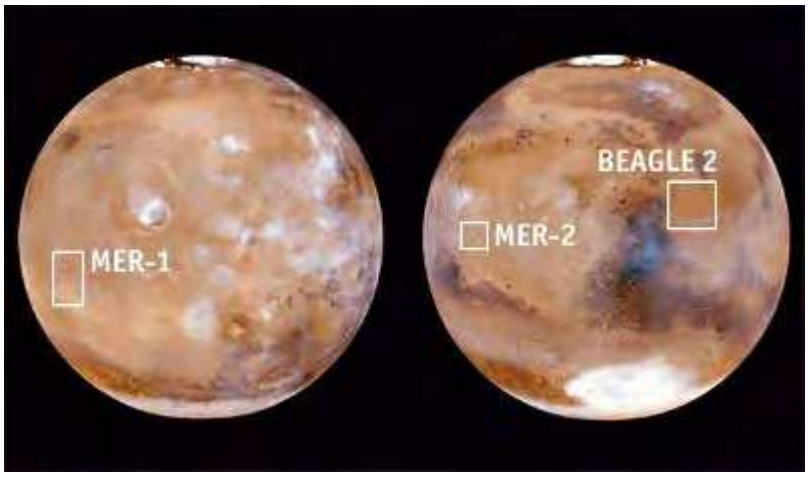
Mars

A ghoul's banquet?

May 29th 2003
From The Economist print edition



Three missions to Mars are scheduled to blast off in June, and another, already on its way, will be joining them

Get article background

THE Great Galactic Ghoul is a mythical space monster that is supposed by some rocket scientists to protect Mars from prying space probes. When contact with a Mars-bound craft is lost for no apparent reason (which happens with monotonous regularity), the ghoul is assumed to have eaten it.

Certainly, sending spacecraft to Mars and landing them on the planet when they have got there is a hazardous business. But the allure of the place is enormous, and, if all goes well, June will see the start of three attempts, by two spacefaring powers, to get past the ghoul and prise free a few more Martian secrets. In particular, they will be looking for evidence of liquid water having flowed at the surface, and also for signs of life.

Mars attacks

The powers concerned are NASA, America's space agency, which is taking two bites at the cherry, and ESA, its European rival. They will be joined on their travels by a Japanese mission launched in 1998, which has taken the long route round in order to get there.

The reason for the rush is that August will see an “opposition” of Mars—the point at which it is closest to Earth. Launching in June makes for the shortest possible crossing. In fact, the majestic clockwork of Newtonian mechanics, combined with details of the elliptical orbits of the two planets, mean that this will be the closest approach between them for 60,000 years.

First off the block are the Europeans. *Mars Express* will rise from Baikonur cosmodrome in Kazakhstan on June 2nd and will go into orbit, ghoul permitting, on December 26th. Five days earlier, it will release a probe called *Beagle 2*, after the naval surveying vessel in which Charles Darwin circumnavigated the globe. *Beagle 2* will bounce down (using a combination of heat-shield, parachutes and air bags) on December 26th as well. It will land (see picture, above) on Isidis Planitia, a large, flat area that is covered with tiny volcanic cones of a sort that, at least on Earth, tend to form when magma comes into contact with sub-surface water.

The two American missions, currently (and rather boringly) known as MER-1 and MER-2 (MER stands for Mars Exploration Rover), should be launched from Cape Canaveral on June 8th and June 25th respectively. They will arrive in January 2004. Given NASA's penchant for renaming probes in mid-mission, they may have different monikers by then. MER-1 will land in Gustev crater, which may be an ancient lake bed (or could just be full of volcanic ash). MER-2 will land at Meridiani Planum, a flatish area which looks as though it may be covered with layers of sediment, suggesting repeated inundations (or, perhaps, repeated blanketings with ash), and which has deposits of haematite, a mineral that often forms in water.

Meanwhile *Nozomi* (or *Hope*, to give the English translation of the name) will arrive at Mars on January 1st 2004. Though it has been in space for almost five years it is, in effect, being relaunched in June. On the 19th, it will swing past Earth in a “slingshot” manoeuvre that will set it on course for Mars. The reason for its long stay in space was that it was launched on a low-powered rocket, and the only way to give it enough oomph to get to Mars was to steal extra energy from Earth's orbit, which is what the slingshot manoeuvre is designed to achieve. *Nozomi* has already performed two such fly-bys, in December 1998 and December 2002. The third one will make it, too, part of the “short crossing” flotilla.

Mars Express has seven instruments designed to probe the planet's atmosphere and rocks. These include a ground-penetrating radar that will be able to look at Martian geology up to 3km below the surface. One of its most important jobs, though, will be to act as a communications relay for *Beagle 2*, and a back-up relay for the MER missions.

Beagle 2 is a formidable piece of design. It weighs a mere 30kg, but is packed with scientific instruments. There are three cameras, including one that is part of a microscope intended to look at freshly ground rock surfaces (there is a rock-grinder, too). There are two spectrometers, one sensitive to gamma rays, and the other to X-rays. These will be able to work out the mineral composition of samples drilled out by a rock-corer. There is a whole battery of sensors for wind, temperature, dust, oxidising chemicals in the atmosphere (which are bad for living things), ultra-violet light (ditto) and so on. And there is a gas-analysis package.

This, for those hoping to find signs of life, is probably the most important instrument. It includes a heater-cum-combustion-chamber to vaporise carbon-containing compounds and convert them into carbon dioxide. It also contains a mass spectrometer to measure the ratio of different isotopes of carbon. That is important because, on Earth, the isotopic ratio is different in compounds that are derived from biological and non-biological sources, since metabolic processes slightly favour one particular isotope. If a biological-looking isotope ratio turns up in Martian rocks, that would be teasing evidence of life.

The two American landers will also be looking for life, of course. These missions have no orbiters (NASA already has two, *Mars Odyssey* and *Mars Global Surveyor*, on station). Instead, they will bounce down directly, using a similar combination of heat-shield, parachutes and airbags to that employed by *Beagle 2*.

The rovers also have some of the same instruments as *Beagle 2*. There are spectrometers, lots of cameras (including one for a microscope) and rock grinders. But the key feature that they have, and the European probe does not, is wheels. If all goes well, each rover will be able to wander the planet at a speed of 100 metres a day for 90 Martian days (a Martian day is 24½ hours). Its batteries will be kept topped up by solar panels.

Nozomi, as befits the product of a relative newcomer to space exploration, is a more modest affair. It will stay in orbit and spend its time measuring Mars's magnetic field and the interaction between the planet's atmosphere and the solar wind of electrically charged particles that streams constantly from the sun's surface. Not, perhaps, as sexy as searching for life. But less likely to run into a ghoulish accident.

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Planetary formation

A stellar striptease

May 29th 2003 | NASHVILLE
From The Economist print edition

Solar systems may form faster than anyone had expected

THE discs found around a type of young star known as a T-Tauri star are textbook examples of how solar systems are supposed to begin. A rotating cloud of gas and dust starts to contract under its own gravity. It heats up in the middle while the outer regions flatten. As the centre's temperature rises to the point at which nuclear fusion can begin, the dust in the flattening disc coalesces. Eventually, the lumps formed by this coalescence stick together to form planets, and the gas clings to them as atmospheres.

What the textbooks spend fewer pages explaining is that, in most T-Tauri stars, this tidy plot tends to unravel part-way through. It ought to take a lot of time to get from small dust particles to objects the size of Earth, let alone the size of Jupiter. Around 10m years is generally reckoned a reasonable estimate. Unfortunately, most T-Tauri stars seem to have lost their discs by the time they are a mere 3m years old.

These “naked” T-Tauri stars pose a problem for the textbooks. They suggest that planets should be rare, but recent observations indicate that they are not. Now new data presented to the summer meeting of the American Astronomical Society, in Nashville, Tennessee, may help to clear the matter up.

Elizabeth Lada of the University of Florida in Gainesville and Karl Haisch of the University of Michigan in Ann Arbor observed four star clusters, each containing dozens of young stars, in the constellations of Orion and Perseus. Using optical telescopes in Hawaii and Arizona, and a radio telescope in Spain, they measured the amount of infra-red and microwave radiation coming from each star. Such radiation is emitted by warm dust, so a young star that is abnormally bright at these wavelengths is assumed to be surrounded by a dusty disc.

All the stars in a cluster are the same age. So taken together, the observations of these clusters show what kinds of disc, if any, stars of different sizes and ages have. It turns out that almost no discs of the sort thought to produce planets are found in clusters more than 3m years old.

Dr Lada is quite certain that these discs are not there. The observations were so sensitive that even at a distance of 1,000 light years an asteroid's-worth of dust would show up in them. On the face of it, that is bad news for theoreticians. If people want to believe that planets form routinely around T-Tauri stars, she concludes, they will have to think of ways to allow this to happen in 3m years instead of 10m.

Jeff Bary and David Weintraub, of Vanderbilt University in Nashville, are not so sure. The observation that the fine dust disappears rapidly is, they say, no reason to think that the manufacture of planets must be a 3m-year rush job. All that is necessary is a partial consolidation into somewhat larger objects—the sorts of object that might be expected to form as intermediaries in the planet-building process.

If this idea is right, then the discs of older T-Tauri stars still contain not only most of their original solid matter, but also most of the accompanying gas (mainly molecular hydrogen). Of itself, this gas would not emit much infra-red radiation. But if suitably excited, it might.

Such excitement could come in the form of X-rays. According to Joel Kastner of the Rochester Institute of Technology in New York state, these could be generated in one of two ways. Dr Kastner has studied X-ray emissions from T-Tauri stars using a satellite called *Chandra*. Some X-rays emanate from matter that falls from the disc towards the star itself. But X-rays are also emitted by giant magnetic short-circuits in the outer layers of the disc—large versions of the flares in the sun's corona.

Whatever the source, such X-rays will cause hydrogen molecules to vibrate, and these vibrations will be released as light of a specific wavelength. Mr Bary and Dr Weintraub used a telescope at Kitt Peak in Arizona to look for light of this wavelength around a naked T-Tauri star. And they found it. Naked stars, it seems, are not naked after all. They are just dressed in a diaphanous incipient solar system.

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Private space travel

The sky's the limit

May 29th 2003 | SAN DIEGO
From The Economist print edition

A new way to escape the gloom of the IT industry. Go into space

OWNING a yacht is *passé*. For those in the information-technology industry lucky enough to have made a fortune during the boom years, there is now a far sexier alternative: owning a rocket. Jeff Bezos, the founder of Amazon, is financing an attempt to build a low-cost reusable spacecraft that can carry people into space. John Carmack, the programming genius behind such computer games as “Doom” and “Quake”, is paying for a similar venture. But most ambitious of all is Elon Musk, who founded two dotcoms—Zip2 and PayPal—and sold them for $307m and $1.5 billion respectively. His goal is Mars.

Mr Musk's original plan, conceived in the months after the sale of PayPal, was to launch a small unmanned probe, costing around $20m, that would have landed on Mars and sent back pictures of a few plants growing inside a sealed environment. By capitalising on the ensuing media coverage, Mr Musk hoped to win support and money for America's space agency, NASA, to mount a manned mission to Mars. But he soon discovered that launching his probe would cost a minimum of $30m, and that started him thinking.

Unlike computing, where costs have been driven steadily down and performance continuously increases, the rocket-launching business has made little progress since the 1960s. Despite several failed attempts by other firms, Mr Musk sensed an opportunity, and set up a new firm, SpaceX, with the goal of building a low-cost launcher. The resulting machine, called *Falcon*, is not technically complex. However, it combines a number of innovations, including the use of modern materials and a reusable first stage, to reduce costs to a mere $6m per launch—the first of which is due later this year.

SpaceX already has customers lined up for its first two commercial launches, which will carry satellites into orbit. Mr Musk then hopes to proceed with his original plan, sending a small probe to Mars and campaigning for a government-backed manned mission. His eyes light up as he talks about humanity becoming a “multi-planetary species”. He cannot be faulted for failing to think big.

Mr Musk outlined his plans at “The Future in Review”, a wide-ranging conference on technology that was held recently in San Diego. His presentation ended a day during which luminaries of the computer industry—including Michael Dell, Craig Mundie of Microsoft and Patrick Gelsinger of Intel—discussed the future of computing. In contrast to the heady days of the internet boom, it is difficult to get excited about grid computing or identity management. Computers have become a commodity, sales are stagnating, the industry is maturing, and there is talk of a “post-technology era” in which innovation takes a back seat to improvements in business processes and supply-chain management. None of which sounds terribly thrilling. Hence the interest in space. What better way to escape the malaise of the computer business than to jump into a rocket?

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Visual perception

Shoot 'em up

May 29th 2003
From The Economist print edition

Playing action games improves visual skills

NOTHING, it seems, is without some redeeming value. Writing in *Nature*, Shawn Green and Daphne Bavelier, of the University of Rochester, in New York state, report the results of a series of tests they performed on two groups of people. One group consisted of experienced players of video games. The other consisted of non-players. It seems that playing games of the sort most censured by parents and moralists—action games such as “Grand Theft Auto III”—improves a person's visual perception.

The first two tests measured the ability to pay attention. One asked the subjects to work out which small shape was within a circle, in the presence of a large “distractor” shape. The other asked them to count the number of squares on a screen. Both tests showed that players pay better attention than non-players, at least within a narrow field of view.

That is not surprising, because video games tend to have just such a restricted field of view. In a third test, however, the subjects had to find a small target (a triangle within a circle) in an extensive field of squares. This test showed that players did much better than non-players even when a wide field of view was involved, a result which suggests that their skills are being generalised.

Mr Green also looked at whether the rapid pace of action games improved the ability to avoid attention bottlenecks. An example of a bottleneck is when people have difficulty detecting a second target if it appears on screen a few tenths of a second after an initial one. Regular players could, indeed, detect a second target almost twice as often as non-players.

Sceptics might argue that video-game players did better on the tests because of pre-existing differences. Mr Green therefore took another group of novices and trained them for an hour a day over the course of ten days. Half the group played “Medal of Honour”, an action game. The other half played “Tetris”, a puzzle game. After the training period, the “Tetris” players had not notably improved on the tests, but the “Medal of Honour” players had. Mr Green supposes that this is because action games require players to do a lot of things at once—look for new enemies, shoot old ones, dodge bullets and so on. “Tetris” players, by contrast, have to focus on a specific task—getting the block in the gap.

This, surely, will please armies, air forces and sports teams, which require people to make split-second decisions based on a rich, wide visual field. Whether parents will welcome their children's arguments that video games are good for you is, of course, another question entirely.

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Indonesia

The unknown archipelago

May 29th 2003
From The Economist print edition

Reuters

Opening the door to one of the world's great nations

THE bookcase of every serious student, amateur or professional, of world affairs will doubtless contain at least a handful of books about China. India will be represented by several more. The United States will surely be accorded a shelf at the least. But how many books will he or she possess on Indonesia—the largest country, in terms of population, after those three? In all probability, none. To most people, Indonesia is a cipher, by far the least-known of the world's great nations. This is especially strange in light of the fact that it is easily the largest Muslim one, with more than three-quarters the number of inhabitants as live in all the Arab states combined. Its strategic significance is no less striking: Indonesia sits on generous oil reserves of its own, and through its waters pass about half of all the world's shipping, including most of the energy requirements of Japan and South Korea. Culturally, too, it is fascinating, its thousands of islands home to a volatile mixture of Muslims and Christians, superimposed on older Hindu and animist traditions. Above all, perhaps, Indonesia is a democracy, if a rather new and fragile one.

Indonesian Destinies
By Theodore Friend

Belknap Press; 640 pages; $35 and £23.50

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Amazon.co.uk

How to account for this neglect? One reason is simply to note that, until fairly recently, Indonesia has been boringly stable, at least since 1966, when General Suharto displaced the country's charismatic but infuriating founder, Sukarno. Under President Suharto, a system was in place in which the army pervaded government totally, through the policy known as *dwi fungsi*, or “dual function”, and kept irritations like separatism, radical Islam and socialism firmly under control. A reliable American ally, Indonesia was even allowed to annex East Timor and Irian Jaya without undue protest. Prior to Mr Suharto's reign, of course, Indonesia was fascinating indeed: Sukarno flirted with communism, famously told the Americans “to hell with your aid”, attempted to fight the British in Borneo, declared 1965 “The Year of Living Dangerously”, and generally ran his country into the ground. But for more than 30 years, Indonesia was not much of a story. George Monbiot told the tale of the Indonesian army's savage repression of Irian Jaya in “Poisoned Arrows”, and Timothy Mo immortalised the sufferings of East Timor in “The Redundancy of Courage”. But on the whole, good Indonesia books have been hard to find.

With luck, that is now changing. The past six years have been extraordinary ones, none more so than 1997, when Indonesia was simultaneously struck by the Asian financial meltdown and devastating fires that ravaged much of its area. By then, Mr Suharto was old, ailing and universally regarded as monumentally corrupt (his wife, Madame Tien, had been known as Madame Tien Percent). In 1998, a year of massed demonstrations and violently suppressed rioting, Mr Suharto was overthrown: but stability has been hard to find. Indonesia has had three presidents since then, and the late 1990s witnessed the emergence of fierce separatist struggles in Aceh, in Irian Jaya and most notably in East Timor, where army-backed militias attempted, unsuccessfully, to prevent the birth of an independent nation, but succeeded in destroying most of it. The violence has continued—this week, Aceh is back at war. And a new phenomenon, of radical Islamic terrorism, has emerged: the Bali bomb of October 2002 has changed Indonesia forever.

Theodore Friend's book is therefore welcome. An engaging romp through the 54 years of Indonesia's existence, its scope is a broad one. Part personal memoir, part history, part economic treatise, it makes for a useful (and bang up-to-date) introduction to the unknown archipelago, particularly valuable in the light of the absence of much in the way of competition. The chaotic Sukarno years are well described, but the book only really comes into its own in Mr Suharto's time, when Mr Friend started visiting Indonesia himself. The drift into corruption and excess, and the gathering storm of retribution, form the book's meat.

Undoubtedly, it could be better: it would have been useful to read much more about the beliefs and membership of Indonesia's two great Muslim groups, Muhammadiyah and Nahdlatul Ulama, each of which claims tens of millions of followers. Religion, in general, is neglected: there should be more, too, on groups like Laskar Jihad and Jemaah Islamiah, accused of planting the Bali bomb. And the presidency of Megawati Sukarnoputri (pictured), Sukarno's daughter, deserves more than a 30-page epilogue. Miss Megawati is accused by human rights groups of trying to reconstruct the authoritarian rule of the man who overthrew her father. Her army chief once offered the chilling prescription: “exterminate provocateurs, shoot rioters”. Her supporters argue that Indonesia is far more democratic now than it has ever been. Mr Friend does not come clearly down on one side or other of this question: he admires her deft populist touch: “I am your mother. Listen to me. I want you to go home,” she once told her rioting supporters. But he is equally repelled by her affinity with the army. Perhaps the president's own *dwi fungsi* is to blame.

Indonesian Destinies.
By Theodore Friend.
Belknap Press; 640 pages; $35 and £23.50

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About sponsorship

Capital punishment

A classic on killing

May 29th 2003
From The Economist print edition

FINDING something new to say about America's love affair with the death penalty is not easy. The subject not only arouses intense emotions, it has produced an ocean of comment from lawyers, judges, politicians, campaigners, statisticians, social scientists and quite a few demagogues. Nevertheless, Franklin Zimring, one of America's leading criminologists, has managed to rise above this cacophony to write a thought-provoking and genuinely original book which deserves to become a classic.

The Contradictions of American Capital Punishment
By Franklin E. Zimring

Oxford University Press; 272 pages; $30 and £13.99

Buy it at
Amazon.com
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Mr Zimring tackles head-on the most puzzling question of all: why are Americans so determined to keep the death penalty when nearly all other developed democracies have given it up, and now view it as barbaric? In the past two decades, attitudes in America and Europe have diverged so much that any dialogue on the subject has been replaced by blank incomprehension, and America's retention of capital punishment has become a significant diplomatic irritant. For European governments the abolition of capital punishment is a human-rights priority, and they have expended valuable political capital in trying to achieve it. American governments, Republican and Democratic, insist that the death penalty has nothing to do with human rights, and deeply resent European efforts to make its abolition an international norm.

The difference between European and American attitudes, says Mr Zimring, is not the breadth of support for the death penalty, but its depth. At the time of the death penalty's abolition in each developed country, a majority similar to America's, currently about 65%, wanted to keep it, according to opinion polls. But when European political elites turned against it after the second world war, electorates acquiesced. Today most Europeans probably would not want it back.

The death penalty is a far more contentious issue in America, says Mr Zimring, because the debate about it draws on a cherished American political tradition which does not exist elsewhere: vigilante justice. Many death-penalty supporters see executions not as acts of a distant or unreliable government, or even as a crime-control measure, but as an instrument of local, community justice, a form of vengeance on behalf of victims' relatives.

In a startling analysis, Mr Zimring shows that most executions are performed in a few states in the south and south-west where the lynching of African-Americans, other forms of mob violence and six-shooter justice were most endemic at the end of the 19th and the first half of the 20th centuries. Opinion-poll support for the death penalty may be fairly uniform across America, and 38 states have the death penalty on their books. But many states hardly ever execute anyone. The vast bulk of executions take place only where the values of the lynch mob have endured, he says.

Many people will find this linkage distasteful. But Mr Zimring marshals a powerful case for it, and sceptics will have to reply to his evidence, not just brush the argument aside. Americans' distrust of overweening government power is as deeply rooted a tradition as vigilante justice, Mr Zimring concedes. However, when it comes to the death penalty, this distrust is manifest not in an abolitionist movement, as in other countries, but in the maze of legal-appeals procedures which mean that most murderers condemned to death spend years, even decades, on death row. More death-row inmates are likely to die of old age than by execution. Neither supporters nor opponents of the death penalty are happy with this odd result.

What Americans really want is an error-free death penalty, but this can never be guaranteed, as the recent spate of death-row exonerations has shown. Moreover, Mr Zimring argues that Americans'

ambivalence about capital punishment can never be resolved. Sooner or later, one of these competing traditions—a regard for careful legal processes to second-guess and constrain government actions, or the desire for vengeance—will have to give way. That will not happen easily. Both date back to the country's very founding.

Mr Zimring believes, on scanty evidence, that Americans will eventually abandon vigilante values, and abolish the death penalty. But even he admits that this will be a messy, bitter affair. And he could well be wrong. His analysis might equally point to another, less palatable outcome: a sweeping aside of legal constraints, and a more rapid pace of executions.

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By Franklin E. Zimring.
Oxford University Press; 272 pages; $30 and £13.99

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Entomology

A bug's game

May 29th 2003
From The Economist print edition

BUGS are pests we try to eliminate from our bodies (and our computers). But Gilbert Waldbauer, an entomologist, is at pains to explain why we should not fear insects, but appreciate their importance and understand their involvement in every aspect of the world around us.

Flowering plants would not exist without them (nor would all those insectivorous animals), and the decomposition and recycling of dead plants and animals, and their excreta, depend upon them. While some insects pollinate plants, others eat them and disperse their seeds, some even defend them from predators. Ants nip the feet of marauding grasshoppers and protect cotton in Guatemala from the boll weevil. Acacia trees reward them by providing extra floral nectaries.

In turn, some birds use ants to free themselves of parasitic mites and lice. In the fourth century BC weaver ants were used by the Chinese to protect their mandarin orange trees from pests, and people have been moving insects purposefully round the globe ever since.

Thus in 1888 a species of beetle from Australia was introduced to California to control scale insects devastating citrus trees and in 1925 a caterpillar from America was introduced to Australia to control the prickly pear which had multiplied to become a nuisance. In 1967 scarab beetles from Europe and Africa were imported to Australia to cope with the dung produced by 30m cattle; native dung beetles only consume the dung of kangaroos and other marsupials.

Plant-eating insects are naturally kept under control by other insects, dragon flies and mantids, for instance, performing wonderful feats by catching them in mid-air. Locusts were popular in biblical times, and even today America's Food and Drug Administration permits peanut butter to contain an average of 30 insect fragments per 100 grams.

Mr Waldbauer's book is filled with information about where insects live and what they do, though not everyone will share his enthusiasm. The text is enhanced by Meredith Waterstraat's drawings which, without Disneyesque coyness, convey the beauty of an acorn weevil, of a mantis eating a horse fly and even of a crab louse holding tight to a pubic hair. It's a bug's life, and not just in Hollywood.

What Good Are Bugs?: Insects in the Web of Life.
By Gilbert Waldbauer.
Harvard University Press; 384 pages; $29.95 and £19.95

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About sponsorship

British media history

King of the castle

May 29th 2003
From The Economist print edition

THERE are few more vivid footnotes in the past 50 years of British politics than the meeting between Lord Mountbatten of Burma and Cecil King, then chairman of IPC, owners of the *Daily Mirror*. It is the doleful climax of this absorbing biography of King and Hugh Cudlipp, the exuberant and innovative tabloid editor who described himself as "the captain of [King's] Praetorian Guard." At the meeting on May 8th 1968, King insisted that an impending economic crisis would lead to the disintegration of the government, bloodshed in the streets and the involvement of the armed forces.

Sir Solly Zuckerman, scientific adviser to the government and a friend of Mountbatten, had been asked along and when King proposed that Mountbatten should lead an alternative government of national unity Zuckerman denounced the idea as "rank treachery". Mountbatten was probably tempted but Zuckerman brought him to his senses. Next, King repeated his scarifying scenario in the *Mirror*. Cudlipp was a constant presence but did not or could not stop him.

King's target was Harold Wilson, who was going through one of his bad prime ministerial patches, but the episode is compelling because of the light it shines on the illusions and delusions of newspaper proprietors. King believed that the *Daily Mirror*—still influential under Cudlipp's spirited editorship—would play a massive part in the coming constitutional upheaval. The real upheaval happened only three weeks later when Cudlipp, whose curious fidelity to King had finally been exhausted, turned the Praetorian Guard on the leader and King was sacked.

The story deflates old assumptions about the power of newspaper proprietors. The heretical concept of the divine right of media magnates was in King's blood. He believed his uncle, Lord Northcliffe, had played a vital part in the removal of H.H. Asquith as prime minister and his replacement by David Lloyd George in 1916. In fact, Max Aitken, soon to become Lord Beaverbrook, had been more influential than Northcliffe, but that was before he owned Express Newspapers. Beaverbrook's subsequent attempts to manipulate British politics—Empire Free Trade to the Common Market—were futile. When Rupert Murdoch wielded real power some years ago, it was a gift from New Labour, but it is hard to imagine either Mr Murdoch or Conrad Black, proprietor of the *Daily Telegraph*, being able to force the government to concede a referendum on the new European Union constitution.

King's fatal error was to believe his own estimate of his power. Ruth Dudley Edwards's book explains precisely why this was so. No flaw is ignored, no scandal is left unexplored—and the story is told briskly and entertainingly. But the book's structure is odd. Having begun to research a biography of King, Ms Dudley Edwards, a former chronicler of the history of *The Economist*, seemed to have fallen for Cudlipp and made him her second subject. He was old Fleet Street, a drinker, generous, inventive, capricious, and an occasional bully. Cudlipp was a much better journalist than company chairman but Ms Dudley Edwards likes him so well that his sins are not so much forgiven as forgotten.

Although King's second marriage to Ruth Railton, a fantasist and bully who may have stoked his delusions of destiny, has an awful fascination, we learn more about King's family than we need to know. And hardly anything at all about the glory days of Fleet Street.

Newspapermen: Hugh Cudlipp, Cecil Harmsworth King, and the Glory Days of Fleet Street.
By Ruth Dudley Edwards.
Secker & Warburg; 516 pages; £20

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About sponsorship

New American fiction

Number one detective agent

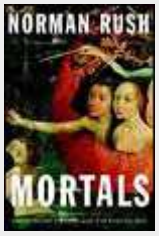
May 29th 2003
From The Economist print edition

IN THE venerable tradition of Graham Greene and John le Carré, Norman Rush has woven international espionage with its equally sordid twin, romantic betrayal. A droll, trenchant novel, “Mortals” dissects intelligence in both senses of the word.

Like his 1991 extravaganza, “Mating,” Mr Rush's second novel is set in Botswana—peaceable to the eye, and one of the few countries in Africa that seems, in western terms, to work. Yet, even this shy, placid backwater was once infiltrated by SWAPO from Namibia, Boer paramilitaries from South Africa, and the ubiquitous CIA making yet another mess.

The eccentric cloak-and-dagger plot involves a black American psychiatrist who would save Africa from religion and a local populist firebrand who would rather save it from cattle. But these shenanigans are at their most appealing as vehicles for two love triangles. At its heart, “Mortals” isn't about political intrigue, but a marriage.

Mortals
By Norman Rush



Knopf; 736 pages; $26.95.
Jonathan Cape; £16.99

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Ray is a quiet school-teacher by day, but a CIA operative once the bell rings. Cynical about the agency, he is, at 49, anything but cynical about his wife, Iris. “Abruptly, he was overjoyed to be going out to walk with her. Abruptly, he loved the idea. The prospect filled him with emotion and reminded him of the answer a philosopher whose name he had forgotten had given when he was asked for an example of an absolute or unalloyed good, and he had said, ‘Having coffee with my wife'.”

Pretty, passionate and clever, yet queasy with her husband's secrecy and professionally at sea, Iris is restive. Nagging depression drives her to seek the services—and the arms—of a psychiatrist, Morel, the evangelical secularist.

Mr Rush is a master at parsing the seemingly casual exchange between true intimates. And although much of the novel is bitterly funny, he also captures the genuine agony of his cuckold. With Iris's affair exposed, Ray “couldn't bear sitting down to eat with Iris because it reminded him of sitting down to eat with Iris.”

Though structurally a sidebar, the second triangle is even richer and more offbeat. The bane of Ray's existence, his brother Rex—an acerbic homosexual dying of AIDS back in America—has been courting Iris's sympathy with a series of long, acidly hilarious letters about her abandoned homeland. In modern America, he warns her never to ask professional people how their kids are doing: “The chances are overwhelmingly high that their children are dysfunctional. And you can be sure that if a child is doing anything that suggests some degree of coping THIS WILL BE VOUCHSAFED TO YOU. Last night a proud father was bragging that his son was working as a sommelier. He was telling EVERYONE.”

The climactic scene, a nutty insurrection, is painfully protracted, and much like “Mating”, the political side of “Mortals” sometimes feels contrived. But these shortcomings are well worth overlooking. Mr Rush has a canny understanding of Africa, a profound appreciation for the fine points of romantic love, a muscular style of description, and an eye for character so frighteningly sharp that it argues against running across the man at parties. His lacerations of religion are especially luscious. To take but one example, he cites, “There but for the grace of God go I” as “a platitude which in itself ought to be enough to destroy religion at the root the moment anyone employing it fully grasped what it meant about God.” Indeed, one could credibly posit that such frou-frou—gratuitous insights and tossed-off one-liners—is really what the novel form is for.

Mortals.
By Norman Rush.
Knopf; 736 pages; $26.95.
Jonathan Cape; £16.99

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Cannes film festival

Bad blood on the Croisette

May 29th 2003 | CANNES
From The Economist print edition

“American values” take a knock

Rolf Konow

Nicole Kidman in “Dogville”

WHEN the Cannes jury gave this year's Golden Palm—and the prize for best director—to Gus Van Sant for “Elephant”, a dull re-enactment of the massacre at Columbine High School in 1999, it perhaps felt it was redressing anti-American bias. Mutual insults were certainly rife. “American cinema is like a dinosaur killing the ecosystem,” said Lee Chang-dong, South Korea's culture minister. Denmark's Lars Von Trier, whose “Dancer in the Dark” won the Golden Palm three years ago, said Americans had criticised him for making a film about the United States without having been there. “They never went to Casablanca when they made Casablanca,” he replied. This year he offended again. His “Dogville”, a Rocky Mountain fable embellished with Depression photographs, roused Todd McCarthy in *Variety* to call it an “ideologically apocalyptic blast at American values”.

Other Americans complained that few films without a French connection were in the competition at all. Gilles Jacob, president of the festival, pointed out that this year American studios had not produced quality films of wide appeal. A Miramax producer, Harvey Weinstein, wondered aloud whether Cannes might lose out to Venice as Europe's premier showcase. For Americans, Cannes was not a happy place.

The jury rewarded two good films: the Iranian Samira Makhmalbaf's “Five in the Afternoon”, about an Afghan girls' school re-opened since the defeat of the Taliban, and the Canadian Denys Arcand's “The Barbarian Invasions”, a genial and humanistic sequel to his 1986 “Decline of the American Empire”, showing the same group of friends in later life.

The best picture in Cannes was Marco Tullio Giordana's “La Meglio Gioventù”, made for television. Lasting six hours it was too long for the official competition. It richly deserved its “Un Certain Regard” prize.

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New British fiction

Rhapsody in gold

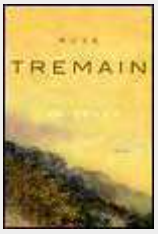
May 29th 2003
From The Economist print edition

GOLD has long been the stuff of men's dreams and the quest for gold, and the emotions that surround it form the backbone of Rose Tremain's tremendous latest novel. “The Colour” is an eloquent portrayal of yearning and greed set in New Zealand in the 1860s when the discovery of gold on the west coast gathered together thousands who were willing to risk their lives “for the hope of something”.

Joseph Blackstone, the unyielding son of a livestock auctioneer, his widowed worrier of a mother, Lilian, and his resolute new wife, Harriet, leave Norfolk, England, for New Zealand in search of a better life. Joseph yearns to flee the tormenting memory of “a disgraceful thing”. Harriet longs to cast off her humdrum existence as a governess. Their mistake in marrying is to confuse their shared resolve to start anew with love.

In New Zealand on a squally, stony piece of ground near Christchurch they try to create a farm. A house with mud walls is built, a milk cow acquired, earth tilled, seeds planted. But, as they labour in relentless weather, the creeping bleakness of their loveless marriage gradually begins to fill Harriet with terror.

The Colour
By Rose Tremain



Farrar, Straus & Giroux; 382 pages; $25.
Chatto & Windus; £16.99

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Joseph's discovery of gold—“the colour”—in a creek unleashes an unwavering obsession. Abandoning farm and family, he travels to Hokitika to seek his fortune amid the madness, squalor, rats, rain, sieves, sluices and shovels of the gold rush. Here, worn down by mud and flood, lonely and desperate, he takes up with Will Sefton, a capricious rent-boy in whose sexual favours he seeks solace.

When tragedy hits the farm, Harriet seeks out Joseph to tell him of their fate. Her arrival at the gold-fields, where she encounters a serene Chinese gardener, is her salvation. With him Harriet discovers the joy of a quiet passion that will unlock her future contentment.

The appeal of “The Colour” lies in Ms Tremain's vivid descriptions of pioneering endeavour and her depiction of characters so real you can smell their sweat. A sub-plot about the mystical union of a boy and his Maori nurse adds breadth to the novel, introducing a flavour of New Zealand's native culture. This is a beautifully crafted book—at once a gripping adventure story and a compelling portrayal of human emotion at its bravest and its most vulnerable.

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By Rose Tremain.
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About sponsorship

Alejandro De Tomaso

May 29th 2003
From The Economist print edition

Alejandro De Tomaso, car maker, died on May 21st, aged 74

ELVIS PRESLEY was an enthusiast for cars, as you would expect an American hero to be. Cadillacs, mainly: he owned about 100 during his lifetime. But in the 1970s, the talk among car buffs was of a sleek Italian-made sports car called the Pantera (Panther in English) and Presley bought one. One day when he fancied a spin, the car would not start. Presley took out a gun and shot it, twice or possibly three times.

It might be thought that the incident, enthusiastically reported around the world, would damage sales of the Pantera. There is nothing more frustrating than a car that will not start. But William Faulkner wrote, “The American really loves nothing but his automobile.” It was felt that even the king of rock and roll had no right to take shots at a car. The Pantera, a car previously confined to a specialist market, became widely famous. Pantera fans sympathised with its creator, Alejandro De Tomaso, when he said that the car, like many a European prima donna, could be temperamental, and should be treated with kindness and patience. The starting problem was a minor matter, he said, to do with overheating, and could be simply remedied. Mr De Tomaso would deal with the problem personally. As for the Presley Pantera, it is now in a museum. Respectful visitors count the wounds.

If, as Faulkner and other writers claimed, America has had a love affair with the car (now possibly fading, as affairs do), this may explain why the Pantera became an object of special affection along with the country's own classics stretching back to Henry Ford's Model T. Mr De Tomaso's achievement was to get his Italian job into a pantheon largely made up of American models. He had an unusual combination of gifts, that of innovator and salesman.

The temptations

One of the problems faced by European manufacturers trying to sell sports cars to America, is that American roads, generally, are not sporty. They are straight and wide and seem to go on for ever, perfect for cruising over long distances, powered by big lazy engines. But even though narrow roads and hairpin bends may be less common in Oklahoma than in Tuscany, Mr De Tomaso felt it was worth making a pitch. Ferrari had tempted some wealthy Americans, but Mr De Tomaso had his eye on a bigger group: youngish professionals who might go for an upmarket car they could just afford, especially if it could bring a new thrill into their lives.

The Pantera had the distinctive look that Italian car designers have evolved, part sculptured elegance and part flash. The car was rock steady at 130mph, and with modifications to keep its nose down was good

for 150mph. In America it was twice the price of a family saloon, but less than half that of a Ferrari. Its engine, positioned in racing-car style behind the driver's seat, was a Ford, so spares were easily available and relatively cheap. Mechanically, it was pretty simple, with the busy parts accessible.

A motoring critic said that driving a Pantera was “a religious experience”. Sterling Moss, a racing driver, more prosaically called it “a real boy-racer”. Enthusiasts accepted it as a genuine “muscle car”. One writer called it a “practical exotic”, which is probably about right.

Mr De Tomaso had started out as a racing driver, a star in the circuit of Buenos Aires, where he was born. In 1955 at the age of 27 he left Argentina, tired of the authoritarian regime of Juan Peron. His grandfather had been Italian, and Mr De Tomaso decided to make the return journey. He moved to Modena, the town where nearly all of Italy's motor manufacturers find it convenient to live together, generously turning a blind eye when they steal each other's experts. Mr De Tomaso got a job with Maserati (which he was later to own for a time).

He worked first as a mechanic and then as a driver of the firm's racing cars. In 1959 he and his second wife Isabelle Haskell, an American who was herself a racing driver of some accomplishment, set up a firm to design and build racing and sports cars. A predecessor to the Pantera was the Mangusta, which gave Mr De Tomaso the experience of mass-producing a speciality car, although only 400 were made. The Mangusta also had a Ford engine, and led to the deal under which Ford supplied the Pantera engine, and displayed the car in its American showrooms. In 1974 Ford ended the deal because of America's new emission laws, but the Pantera continued to be manufactured and it was sold into the 1990s in other countries.

These days the Pantera has vintage value. There are thought to be about 3,500 Panteras in America in various conditions. $25,000 will buy one in good order, without rust (Mr De Tomaso was a bit lax about rustproofing), and prices are said to rising. A cottage industry has grown up that will fix most problems. Some owners put them on the road, perhaps to a rally. But many Panteras are confined to a pampered life, washed and waxed. Only occasionally is the engine allowed to come to life, with the owner listening nostalgically to the roar of its great carburettor gulping volumes of air, happily polluting the atmosphere as it used to before environmentalists spoiled all the fun.

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Overview

May 29th 2003
From The Economist print edition

American consumers continue to rebound from their war-induced jitters, according to the Conference Board. Its consumer-confidence index rose to 83.8 in May, from 81.0 in April. Respondents are, however, more bullish about the future than they are encouraged by the present; their estimate of "current conditions" fell in May compared with April, and more people said that jobs were hard to find. Even so, America's housing market continued to shine, as unit sales of both new and second-hand houses rose strongly in April.

America's **Nasdaq** stockmarket rose to near a one-year high. The **yield** on America's ten-year Treasury bond fell to 3.29%, near a 45-year low.

The **euro** briefly rose to its highest level against the **dollar**, $1.19, since the launch of Europe's single currency in 1999.

Germany's economy struck a rare note of optimism in the Ifo survey of business confidence, which rose from 86.6 in April to 87.6 in May. In the year to March, German industrial production was revised up to 0.5% growth, from an earlier estimate of a 0.4% fall. In **France**, business sentiment was unchanged in May, according to an INSEE survey, and retail sales rose by 2.1% in the year to April. **Spain's** GDP grew by 2.1% in the year to the first quarter.

The **euro area's** M3 broad-money supply measure grew by 8.7% in the year to April.

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Output, demand and jobs

May 29th 2003
From The Economist print edition

% change on year ago

	GDP latest		GDP qtr*	The Economist poll GDP forecasts 2003	2004	Industrial production latest		Retail sales (volume) latest		Unemployment % rate latest		year ago
Australia	+ 3.0	Q4	+ 1.6	+ 3.0	+ 3.5	+ 2.3	Q4	+ 4.0	Q1	6.1	Apr	6.3
Austria	+ 1.3	Q4	– 0.5	+ 0.9	+ 1.8	– 1.5	Dec	+ 0.9	Dec	4.3	Mar	4.0
Belgium	+ 1.3	Q1	+ 0.6	+ 1.1	+ 2.1	– 0.1	Mar	– 5.3	Feb	11.6	Apr†	10.5
Britain	+ 2.2	Q1	+ 0.3	+ 1.8	+ 2.4	– 0.8	Mar	+ 2.7	Apr	5.1	Mar††	5.1
Canada	+ 3.9	Q4	+ 1.6	+ 2.7	+ 3.2	+ 1.9	Feb	+ 2.2	Feb	7.5	Apr	7.6
Denmark	+ 0.9	Q4	– 0.1	+ 1.5	+ 2.2	– 1.6	Mar	+ 5.8	Feb	5.8	Mar	5.0
France	+ 1.0	Q1	+ 1.0	+ 1.2	+ 2.1	+ 0.5	Mar	+ 2.1	Apr	9.3	Mar	8.9
Germany	+ 0.2	Q1	– 0.9	+ 0.4	+ 1.5	+ 0.5	Mar	– 4.0	Mar	10.7	Apr§	9.6
Italy	+ 0.8	Q1	– 0.4	+ 1.0	+ 1.9	– 0.7	Mar	+ 0.8	Feb‡	9.0	Jan	9.0
Japan	+ 2.7	Q1	nil	+ 0.7	+ 0.8	+ 3.6	Apr	– 0.8	Mar	5.4	Mar	5.3
Netherlands	– 0.1	Q1	– 1.2	+ 0.5	+ 1.6	– 5.6	Mar	– 2.5	Dec	5.1	Apr**	3.8
Spain	+ 2.1	Q1	+ 1.9	+ 2.1	+ 2.6	+ 9.5	Mar	+ 2.3	Feb	11.5	Mar	11.2
Sweden	+ 1.3	Q4	+ 1.2	+ 1.5	+ 2.3	– 3.9	Mar	+ 2.6	Mar	4.6	Apr†	3.8
Switzerland	+ 0.8	Q4	+ 1.4	+ 0.8	+ 1.6	– 2.1	Q4	– 3.1	Feb	3.9	Apr†	2.5
United States	+ 2.1	Q1	+ 1.6	+ 2.2	+ 3.2	– 0.4	Apr	+ 4.6	Mar	6.0	Apr	5.9
Euro area	+ 0.8	Q1	nil	+ 1.1	+ 2.1	– 0.3	Mar	+ 0.7	Feb	8.7	Mar	8.2
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 2.8	Q4	+ 2.8	na	na	– 2.0	Mar	+ 4.9	Feb	10.4	Apr†	10.4
Greece	+ 4.3	Q1	na	na	na	+ 0.8	Mar	na		na		na
Iceland	– 3.0	Q4	na	na	na	– 0.3	2002	na		3.9	Apr†	2.6
Ireland	+ 6.4	Q4	na	na	na	– 5.6	Mar	– 2.0	Feb	4.6	Apr	4.2
Luxembourg	+ 1.0	2001	na	na	na	– 2.1	Feb	+ 9.7	Dec	3.7	Mar	2.8
New Zealand	+ 4.2	Q4	+ 2.0	na	na	+ 5.9	Q4	+ 6.4	Q1	5.0	Q1	5.3
Norway	– 0.1	Q4	+ 0.9	na	na	+ 2.2	Mar	+ 4.5	Apr	4.4	Q1	4.1
Portugal	– 1.3	Q4	– 3.1	na	na	– 4.5	Mar	+ 2.3	Feb	6.4	Q1†	4.5

*% change at an annual rate. †Not seasonally adjusted. ‡New series. ††Jan-Mar; claimant count rate 3.1% in Apr. §EU harmonised rate 9.4% in April. **Feb-Apr.

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Prices and wages

May 29th 2003
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2003	2004	latest		year ago	latest		year ago
Australia	+ 3.4	Q1	+ 2.9	+ 2.7	+ 2.5	+ 3.0	Q1	+ 0.5	+ 4.3	Q1	+ 4.1
Austria	+ 1.3	Apr	+ 1.8	+ 1.5	+ 1.3	+ 0.8	Apr	– 0.5	+ 2.2	Apr	+ 2.4
Belgium	+ 1.0	May	+ 1.3	+ 1.4	+ 1.4	+ 0.2	Apr	– 0.2	+ 2.4	Q1	+ 3.1
Britain	+ 3.1	Apr	+ 1.5	+ 2.8	+ 2.4	+ 1.7	Apr	+ 0.2	+ 3.4	Mar	+ 2.9
Canada	+ 3.0	Apr	+ 1.7	+ 3.1	+ 2.2	+ 1.3	Mar	– 1.0	+ 2.1	Feb	+ 3.5
Denmark	+ 2.5	Apr	+ 2.4	+ 2.3	+ 1.9	– 0.5	Apr	+ 0.3	+ 3.9	Q4	+ 4.1
France	+ 2.0	Apr	+ 2.0	+ 1.8	+ 1.4	+ 1.0	Apr	– 0.6	+ 2.9	Q1	+ 4.0
Germany	+ 0.7	May	+ 1.2	+ 1.1	+ 0.9	+ 0.3	Apr	– 0.5	+ 3.7	Mar	+ 2.6
Italy	+ 2.7	Apr	+ 2.3	+ 2.3	+ 1.9	+ 2.0	Apr	– 0.8	+ 1.7	Mar*	+ 2.1
Japan	– 0.1	Mar	– 1.2	– 0.6	– 0.5	– 0.8	Apr	– 2.3	+ 2.5	Mar	– 0.9
Netherlands	+ 2.5	Apr	+ 3.5	+ 2.5	+ 2.1	+ 2.5	Apr	– 1.0	+ 2.8	Mar	+ 4.4
Spain	+ 3.1	Apr	+ 3.6	+ 3.0	+ 2.6	+ 1.4	Apr	+ 0.5	+ 3.9	Q4	+ 3.7
Sweden	+ 2.3	Apr	+ 2.5	+ 2.4	+ 1.8	+ 0.6	Mar	– 0.4	+ 2.1	Feb	+ 3.3
Switzerland	+ 0.7	Apr	+ 1.1	+ 0.8	+ 0.9	– 0.3	Apr	– 1.4	+ 1.8	2002	+ 2.5
United States	+ 2.2	Apr	+ 1.6	+ 2.3	+ 1.7	+ 2.4	Apr	– 2.1	+ 3.1	Apr	+ 3.2
Euro area	+ 2.1	Apr	+ 2.3	+ 1.9	+ 1.5	+ 2.4	Mar	– 0.8	+ 3.4	Q4	+ 3.2
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 1.1	Apr	+ 1.8	na	na	+ 0.8	Mar	– 0.8	+ 3.3	Q4	+ 4.5
Greece	+ 3.4	Apr	+ 3.8	na	na	+ 2.0	Mar	+ 4.2	na		na
Iceland	+ 2.2	May	+ 5.9	na	na	+ 3.3	Apr	+ 8.7	+ 5.6	Apr	+ 8.0
Ireland	+ 4.3	Apr	+ 4.8	na	na	– 7.1	Mar	+ 0.7	+ 6.8	Q4	+ 7.8
Luxembourg	+ 2.2	Apr	+ 2.1	na	na	+ 2.8	Mar	– 3.0	– 0.4	Feb	+ 2.5
New Zealand	+ 2.5	Q1	+ 2.6	na	na	– 0.9	Q4	+ 1.8	+ 2.3	Q1	+ 2.1
Norway	+ 2.9	Apr	+ 0.5	na	na	– 4.9	Apr	– 4.7	+ 5.3	Q1	+ 4.6
Portugal	+ 3.7	Apr	+ 3.6	na	na	+ 2.0	Apr	+ 0.2	+ 0.6	Feb	+ 0.6

*New series.

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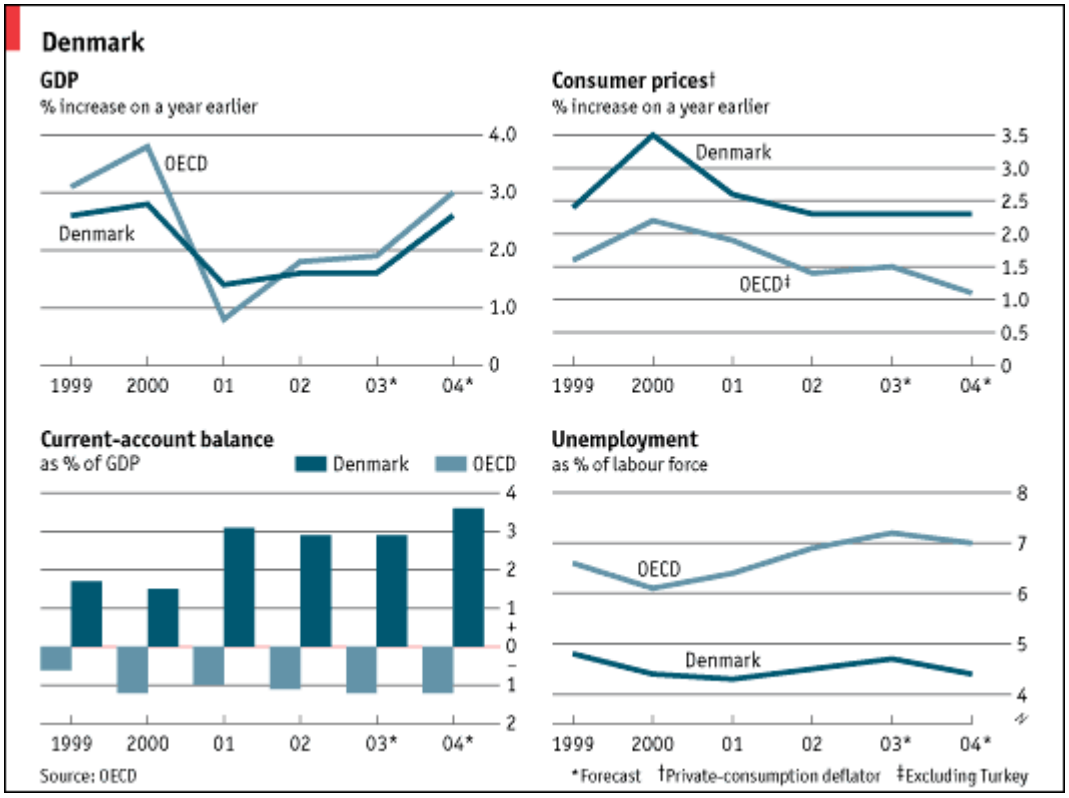
Denmark

May 29th 2003
From The Economist print edition



Denmark's economy is in much better shape than most others in Europe. It has weathered the global downturn relatively well, with a healthy fiscal surplus and annual GDP growth bottoming out at 1.4% in 2001. Yet Denmark, like other rich countries, faces a demographic crunch, as the number of workers for every pensioner is going to fall. In a new report, the OECD reckons that Denmark could do more to increase labour-force participation. Despite a recent tax cut for poorer Danes, for example, the top marginal income-tax rate is still 63%, and this tax bracket affects two in every five workers. Other measures that the OECD urges to help Danes choose work over leisure include limiting the duration and lavishness of unemployment benefits, cutting the number of years that university students take to complete their degrees, and helping immigrants to find work.

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Money and interest rates

May 29th 2003
From The Economist print edition

	Money supply* % change on year ago			Interest rates % p.a. (May 28th 2003)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	−10.0	+10.6	Mar	4.78	4.91	4.45	4.92	6.24	5.72
Britain	+ 8.6	+ 7.9	Apr	3.56	4.13	3.31	4.10	5.24	5.66
Canada	+ 6.2	+ 5.7	Apr	3.16	2.60	3.17	4.59	5.53	6.35
Denmark	+ 7.4	+ 9.7	Apr	2.53	3.70	2.32	3.97	5.32	5.29
Japan	+ 4.7	+ 1.4	Apr	0.02	0.02	0.04	0.53	1.38	0.64
Sweden	+ 2.2	+ 5.9	Mar	3.04	4.25	3.16	4.22	5.59	3.60
Switzerland	+27.5	+11.3	Apr	0.28	1.27	0.18	2.26	3.32	3.09
United States	+ 5.3	+ 6.5	Apr	1.19	1.75	1.28	3.41	5.07	5.34
Euro area†	+11.1	+ 8.7	Apr	2.29	3.50	2.18	3.74	5.09	3.91

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. Benchmarks: US 30-year 4.41%, Japan No.249 0.52%. Central bank rates: US fed funds 1.25%, ECB refinancing 2.50%, BOJ overnight call 0.001%, BOE repo 3.75%. Sources: Commerzbank, Danske Bank, J.P. Morgan Chase, Royal Bank of Canada, Stockholmsbörsen, UBS Warburg, Global Insight, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

May 29th 2003
From The Economist print edition

1995=100

	May 13th*	May 20th	May 27th†	% change on one month	% change on one year
Dollar index					
All items	77.2	77.6	77.0	+ 1.8	+11.6
Food	80.2	80.2	79.1	+ 1.1	+14.1
Industrials					
All	73.1	74.1	74.2	+ 2.9	+ 8.3
Nfa‡	73.9	76.2	75.6	+ 0.0	+ 9.6
Metals	72.5	72.4	73.1	+ 5.6	+ 7.2
Sterling index					
All items	75.7	74.9	74.0	– 1.3	– 0.5
Euro index					
All items	88.1	87.6	85.3	– 5.5	–12.6
Yen index					
All items	85.8	96.5	95.8	– 0.9	+ 4.8
Gold					
$ per oz	350.70	367.75	370.65	+11.0	+14.3
West Texas Intermediate					
$ per barrel	28.57	29.10	29.22	+15.8	+16.5

* Revised. † Provisional. ‡ Non-food agriculturals.

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About sponsorship

Stockmarkets

May 29th 2003
From The Economist print edition

Market indices

	May 28th	2003 high	2003 low	% change on one week	% change on record high	% change on Dec 31st 2002 in local currency	% change on Dec 31st 2002 in $ terms
Australia (All Ordinaries)	2,976.1	3,049.6	2,673.3	+ 2.1	-13.5	+ 0.0	+15.1
Austria (ATX)	1,285.0	1,325.7	1,120.2	- 1.9	-26.0	+11.7	+25.0
Belgium (Bel 20)	1,909.4	2,074.1	1,426.6	+ 1.7	-48.1	- 5.7	+ 5.5
Britain (FTSE 100)	4,071.9	4,071.9	3,287.0	+ 3.4	-41.2	+ 3.3	+ 4.9
Canada (Toronto Composite)	6,836.2	6,840.2	6,228.6	+ 1.6	-40.0	+ 3.4	+91.7
Denmark (KBX)	179.0	180.5	145.0	- 0.2	-40.7	+ 7.7	+20.5
France (SBF 250)	1,997.1	2,144.8	1,630.1	+ 2.4	-54.5	- 2.7	+ 8.8
(CAC 40)	2,949.6	3,210.3	2,403.0	+ 2.4	-57.4	- 3.7	+ 7.7
Germany (DAX)	2,919.5	3,157.3	2,203.0	+ 3.3	-63.8	+ 0.9	+12.9
Italy (BCI)	1,143.3	1,143.3	959.4	+ 4.5	-47.6	+ 4.7	+17.1
Japan (Nikkei 225)	8,234.2	8,790.9	7,607.9	+ 2.7	-78.8	- 4.0	- 4.0
(Topix)	822.3	865.4	770.6	+ 1.5	-71.5	- 2.5	- 2.4
Netherlands (AEX)	278.6	337.3	218.4	+ 3.7	-60.3	-13.7	- 3.4
Spain (Madrid SE)	675.4	684.6	576.8	+ 3.9	-41.1	+ 6.5	+19.2
Sweden (Affarsvarlden Gen)	149.0	153.4	127.8	+ 3.6	-62.8	+ 2.6	+14.8
Switzerland (Swiss Market)	4,664.8	4,965.3	3,675.4	+ 4.8	-44.5	+ 0.7	+ 7.2
United States (DJIA)	8,793.1	8,842.6	7,524.1	+ 3.2	-25.0	+ 5.4	+ 5.4
(S&P 500)	953.2	953.2	800.7	+ 3.2	-37.6	+ 8.3	+ 8.3
(NASDAQ Comp)	1,563.2	1,563.2	1,271.5	+ 4.9	-69.0	+17.1	+17.1
Europe (FTSE Eurotop 300)*	822.3	890.8	682.7	+ 3.1	-51.8	- 4.1	+ 7.3
Euro area (FTSE Ebloc 100)*	696.8	757.2	565.7	+ 3.3	-55.1	- 3.0	+ 8.5
World (MSCI)†	850.7	850.7	710.8	+ 3.0	-41.3	na	+ 7.4
World bond market (Citigroup)‡	571.3	579.1	518.6	- 0.4	- 0.4	na	+ 8.8

*In euro terms. †Morgan Stanley Capital International index includes individual markets listed above plus eight others, in dollar terms.
‡Citigroup World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

May 29th 2003
From The Economist print edition

	Trade balance*, $bn latest 12 months		Current account $bn latest 12 mths		The Economist poll % of GDP, forecast 2003	2004	Exchange rate trade-weighted† 1990=100 May 28th	year ago	Currency units per $ May 28th	year ago	per £	per euro	per ¥100	Budget balance % of GDP 2003‡
Australia	− 9.0	Apr	− 17.7	Q4	− 4.7	− 4.0	81.0	77.5	1.54	1.77	2.52	1.81	1.30	0.2
Austria	+ 0.7	Feb	+ 1.4	Mar	− 0.1	− 0.2	102.0§	100.1	0.85	1.07	1.39	–	0.72	-1.3
Belgium	+ 16.4	Mar	+ 11.4	Jan	+ 5.0	+ 5.0	102.0§	98.8	0.85	1.07	1.39	–	0.72	nil
Britain	− 56.8	Mar	− 13.1	Q4	− 1.6	− 1.4	97.6	103.9	0.61	0.68	–	0.72	0.52	-1.9
Canada	+ 36.4	Mar	+ 11.0	Q4	+ 1.5	+ 1.6	84.2	78.1	0.85	1.53	1.39	1.00	0.72	1.1
Denmark	+ 8.7	Mar	+ 5.5	Mar	+ 2.3	+ 2.2	107.0	102.5	6.32	7.98	10.3	7.42	5.33	1.6
France	+ 8.4	Mar	+ 28.6	Mar	+ 1.8	+ 1.5	105.2§	101.4	0.85	1.07	1.39	–	0.72	-3.6
Germany	+123.0	Mar	+ 48.0	Mar	+ 1.9	+ 1.6	102.5§	98.2	0.85	1.07	1.39	–	0.72	-3.7
Italy	+ 6.0	Mar	− 9.6	Feb	− 0.3	− 0.3	75.0§	72.3	0.85	1.07	1.39	–	0.72	-2.4
Japan	+ 94.7	Mar	+109.9	Mar	+ 2.7	+ 2.9	127.1	133.1	119	124	194	139	–	-7.7
Netherlands	+ 28.5	Mar	+ 2.9	Q1	+ 3.1	+ 3.1	101.4§	97.7	0.85	1.07	1.39	–	0.72	-1.6
Spain	− 42.0	Feb	− 18.2	Feb	− 2.2	− 2.1	76.4§	74.1	0.85	1.07	1.39	–	0.72	-0.4
Sweden	+ 15.5	Apr	+ 9.9	Dec	+ 3.6	+ 3.5	81.3	76.7	7.78	9.8	12.7	9.14	6.56	0.7
Switzerland	+ 5.0	Apr	+ 32.0	Q4	+11.7	+11.7	114.2	113.4	1.30	1.57	2.12	1.53	1.10	na
United States	−514.3	Mar	−503.4	Q4	− 5.3	− 5.4	102.7	116.9	–	–	1.63	1.17	0.84	-4.6
Euro area	+ 87.2	Mar	+ 48.0	Mar	+ 0.8	+ 0.7	91.8	80.4	0.85	1.07	1.39	–	0.72	-2.5
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*													
Finland	+ 13.3	Mar	+ 9.9	Mar	na	na	81.0§	77.8	0.85	1.07	1.40	–	0.72	3.1
Greece	− 22.8	Mar	− 11.1	Mar	na	na	59.0§	57.4	0.85	1.07	1.40	–	0.72	-1.0
Iceland	+ 0.1	Apr	nil	Q4	na	na	96.0**	84.9	72.4	92.0	118	85.0	61.1	nil
Ireland	+ 36.3	Feb	− 0.2	Q4	na	na	93.0§	86.9	0.85	1.07	1.40	–	0.72	-0.8
Luxembourg	− 3.0	Jan	+ 1.7	Q4	na	na	102.0§	98.8	0.85	1.07	1.40	–	0.72	0.2
New Zealand	− 0.9	Apr	− 1.9	Q4	na	na	97.3	88.9	1.74	2.10	2.84	2.04	1.47	0.8
Norway	+ 27.9	Apr	+ 28.1	Feb	na	na	102.6	104.3	6.72	7.94	11.0	7.89	5.66	11.3
Portugal	− 12.5	Feb	− 8.8	Feb	na	na	92.2**	90.1	0.85	1.07	1.40	–	0.72	-3.2

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †Bank of England except §IMF, March average. ‡OECD forecast. **IMF, January average.

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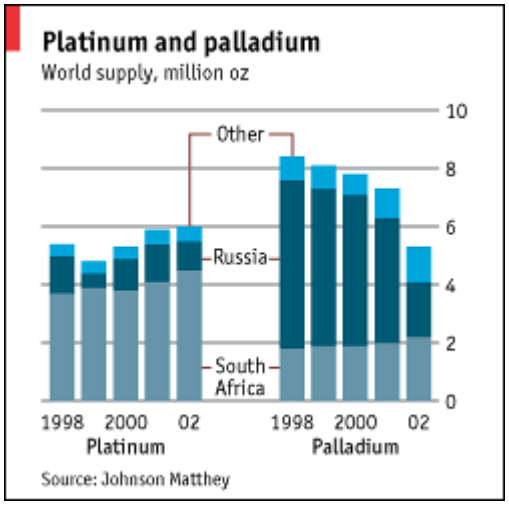
Platinum and palladium

May 29th 2003
From The Economist print edition

The supply of palladium, used in cars' exhaust filters, fell to a nine-year low in 2002. High prices have led carmakers to shift away from the metal and towards others, such as platinum, which saw supply growth of 2% last year. Most of this growth came from South Africa.



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Overview

May 29th 2003
From The Economist print edition

Venezuela's economy is in agony, thanks to the effects of a general strike and to the government's imposition of currency controls. In the year to the first quarter, Venezuelan GDP contracted by 29%, the biggest drop ever recorded. Around 2,000 companies have closed since the start of 2003, reckons one industry association. In contrast, **Colombia's** war-racked economy managed to achieve 3.8% growth in the year to the first quarter, owing in part to robust growth in construction.

Malaysia's GDP rose by 4.0% in the year to the first quarter.

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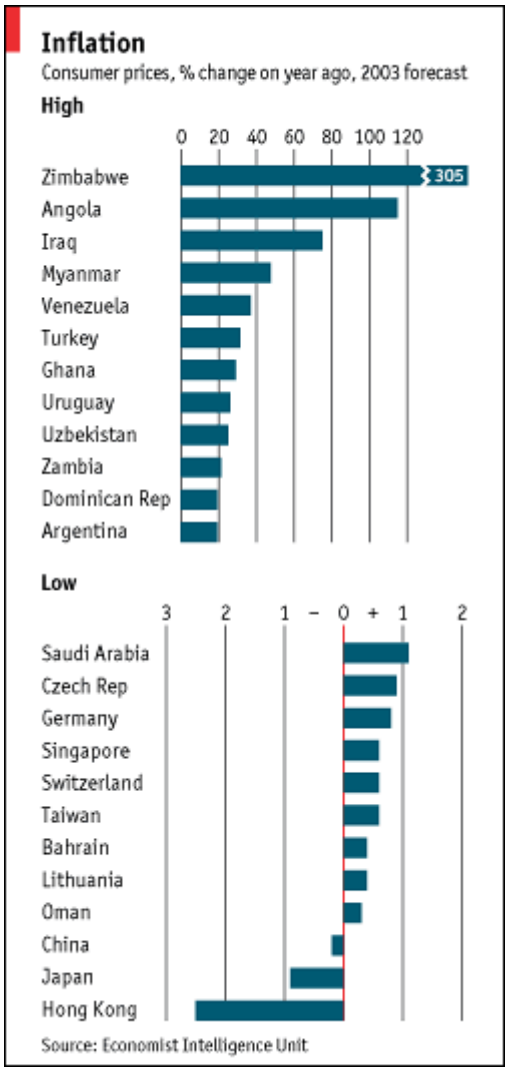
Inflation

May 29th 2003
From The Economist print edition

Zimbabwe will have the world's highest inflation this year, according to forecasts by the Economist Intelligence Unit (EIU), a sister organisation of *The Economist*. In 2003, the EIU expects consumer prices in Zimbabwe to rise by over 300% as the economy continues to collapse. Angola, another stumbling African economy, will have inflation of 115%. Iraq comes third: consumer prices are likely to rise by 75%. At the other extreme, Hong Kong's consumer prices are poised to fall by 2.5% in 2003, the fastest rate of deflation in the world.



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Economy

May 29th 2003
From The Economist print edition

	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+ 9.9	Q1	+14.9	Apr	+ 1.0	Apr	+22.0	Apr	+35.4	2002	312.9	Feb
Hong Kong	+ 5.0	Q4	– 9.2	Q4	– 1.8	Apr	– 8.0	Apr	+13.8	Q4	114.2	Apr
India	+ 2.6	Q4	+ 6.0	Mar	+ 4.1	Mar	– 9.0	Mar	+ 4.8	Q4	73.5	Apr
Indonesia	+ 3.4	Q1	+29.2	Feb	+ 7.5	Apr	+25.6	Mar	+ 7.1	Q3	31.6	Mar
Malaysia	+ 4.0	Q1	+ 5.0	Mar	+ 1.0	Apr	+14.7	Mar	+ 7.3	Q4	33.8	Mar
Philippines	+ 4.5	Q1	+ 7.3	Mar	+ 2.8	Apr	– 0.1	Mar	+ 3.1	Feb	13.1	Apr
Singapore	+ 1.6	Q1	– 5.0	Apr	+ 0.9	Apr	+11.5	Apr	+21.3	Q1	83.4	Apr
South Korea	+ 3.7	Q1	+ 1.8	Apr	+ 3.7	Apr	+ 7.8	Apr	+ 2.6	Apr	123.6	Apr
Taiwan	+ 3.2	Q1	– 0.7	Apr	– 0.1	Apr	+16.5	Apr	+26.0	Q1	170.6	Apr
Thailand	+ 6.1	Q4	+12.7	Mar	+ 1.6	Apr	+ 3.9	Mar	+ 8.5	Mar	36.8	Mar
Argentina	+ 5.2	Q1	+12.6	Apr	+19.4	Apr	+16.7	Mar	+ 8.9	Q4	11.0	Apr
Brazil	+ 3.4	Q4	+ 3.5	Mar	+17.4	Apr	+17.1	Apr	– 3.4	Apr	42.3	Mar
Chile	+ 3.5	Q1	+ 6.9	Mar	+ 4.0	Apr	+ 2.2	Apr	– 0.6	Q1	15.9	Apr
Colombia	+ 3.8	Q1	+ 5.0	Feb	+ 7.8	Apr	– 0.4	Feb	– 1.6	Q4	10.5	Apr
Mexico	+ 2.3	Q1	+ 3.8	Mar	+ 5.3	Apr	– 6.9	Apr	–14.5	Q4	53.7	Apr
Peru	+ 5.2	Mar	+ 5.5	Mar	+ 2.6	Apr	+ 0.3	Mar	– 1.1	Q4	9.8	Apr
Venezuela	–29.0	Q1	–14.7	Mar	+33.5	Apr	+15.0	Q1	+ 9.5	Q1	8.4	Feb
Egypt	+ 3.1	2002†	+ 4.2	2002†	+ 3.1	Feb	– 7.4	Jan	+ 0.5	Q4	13.1	Apr
Israel	+ 0.3	Q1	+ 2.9	Mar	+ 3.1	Apr	– 5.8	Apr	– 2.1	Q4	23.4	Apr
South Africa	+ 2.5	Q1	– 0.7	Mar	+12.5	Mar	+ 3.6	Mar	+ 0.3	Q4	6.1	Mar
Turkey	+11.4	Q4	+ 5.6	Mar	+29.5	Apr	–17.3	Mar	– 3.7	Mar	26.9	Apr
Czech Republic	+ 1.5	Q4	+ 7.0	Mar	– 0.1	Apr	– 2.7	Apr	– 3.5	Q4	24.6	Apr
Hungary	+ 3.7	Q4	+ 4.2	Mar	+ 3.9	Apr	– 2.5	Mar‡	– 3.3	Mar	12.8	Apr
Poland	+ 2.1	Q4	+ 8.3	Apr	+ 0.3	Apr	– 9.9	Mar	– 5.8	Mar	29.9	Apr
Russia	+ 5.2	Q4	+ 7.1	Apr	+14.7	Apr	+52.2	Mar	+38.3	Q1	56.1	Apr
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*												
Pakistan	+ 3.6	2002†	+15.8	Nov	+ 2.2	Apr	– 1.5	Apr	+ 2.7	2002†	10.3	Mar
Saudi Arabia	+ 0.7	2002§	na		– 0.9	Jan	+38.6	2002§	+11.7	2002	22.8	Mar

*Excluding gold, except Singapore; IMF definition. †Year ending June. ‡New series. §Economist Intelligence Unit estimate.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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Financial markets

May 29th 2003
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	May 28th		Dec 31st 2002	
	May 28th	year ago	May 28th	% p.a.		one week	in local currency	in $ terms
China	8.28	8.28	13.5	na	1,624.7	+1.2	+ 14.5	+ 14.5
Hong Kong	7.80	7.80	12.7	1.32	9,510.6	+5.0	+ 2.0	+ 2.0
India	46.9	49.0	76.7	4.49	3,130.5	+2.4	– 7.3	– 5.3
Indonesia	8,250	8,850	13,477	11.28	492.8	+5.7	+ 16.0	+ 25.8
Malaysia	3.80	3.80	6.21	3.10	664.0	+3.7	+ 2.7	+ 2.7
Philippines	53.1	50.1	86.7	7.56	1,047.8	+0.2	+ 2.9	+ 3.5
Singapore	1.73	1.79	2.83	0.63	1,338.6	+3.7	– 0.2	– 0.0
South Korea	1,200	1,224	1,961	4.32	628.4	+4.6	+ 0.1	– 1.1
Taiwan	34.7	34.2	56.6	1.25	4,474.4	+6.1	+ 0.5	+ 0.8
Thailand	41.8	42.5	68.3	1.75	403.0	+4.0	+ 13.0	+ 16.6
Argentina	2.88	3.51	4.70	5.20	678.0	+6.9	+ 29.2	+ 51.0
Brazil	3.02	2.52	4.93	26.31	13,294.3	+2.0	+ 18.0	+ 38.3
Chile	713	654	1,165	2.64	5,880.9	+3.1	+ 17.2	+ 18.3
Colombia	2,876	2,317	4,699	7.81	1,967.1	+7.2	+ 22.3	+ 21.9
Mexico	10.39	9.62	17.0	4.91	6,667.4	+4.0	+ 8.8	+ 9.6
Peru	3.50	3.47	5.72	3.76	1,789.3	+0.1	+ 28.5	+ 29.1
Venezuela	1,598	1,086	2,610	16.51	11,532.9	+24.4	+ 43.9	+ 24.9
Egypt	5.97	4.63	9.75	10.97	8,146.2	+4.3	+ 51.7	+ 17.6
Israel	4.42	4.95	7.22	5.30	433.6	+12.7	+ 30.4	+ 40.2
South Africa	8.2	9.8	13.4	13.10	8,580.6	+5.8	– 7.5	– 3.2
Turkey	1,443,500	1,418,000	2,358,102	39.00	11,437.4	+8.5	+ 10.3	+ 26.8
Czech Republic	26.7	32.8	43.6	2.44	552.2	+0.2	+ 19.9	+ 35.1
Hungary	210	261	343	6.49	8,332.6	–0.1	+ 6.9	+ 14.3
Poland	3.71	4.04	6.06	5.41	15,068.7	+1.2	+ 4.9	+ 8.4
Russia	30.6	31.3	50.0	18.00	471.2‡	+6.5	+ 25.8	+ 31.2
EMF (MSCI)*	1.00	1.00	1.63	na	312.9	+4.2	na	+ 7.1
EMBI+†	1.00	1.00	1.63	na	271.6	+0.8	na	+ 18.7

*Emerging Mkts Free. †J.P. Morgan Chase's Emerging Mkts Bond Index Plus. ‡ In $ terms.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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